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ECONOMIC EFFECTS OF TRADE LEGISLATION

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HEARING

BEFORE THE

SUBCOMMITTEE ON ECONOMIC GOALS AND INTERGOVERNMENTAL POLICY

OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

NINETY-NINTH CONGRESS

FIRST SESSION

SEPTEMBER 18, 1985

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ECONOMIC EFFECTS OF TRADE LEGISLATION

WEDNESDAY, SEPTEMBER 18, 1985

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON ECONOMIC GOALS
AND INTERGOVERNMENTAL POLICY
OF THE JOINT ECONOMIC COMMITTEE,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room SD-342, Dirksen Senate Office Building, Hon. Lloyd Bentsen (vice chairman of the subcommittee) presiding.

Present: Senator Bentsen; and Representatives Scheuer, Snowe, and Fiedler.

Also present: George R. Tyler, John Starrels, and Kenneth Brown, professional staff members.

OPENING STATEMENT OF SENATOR BENTSEN, VICE CHAIRMAN

Senator BENTSEN. This hearing will come to order.

A consensus is emerging that we face a trade crisis in this country and a debate is beginning about what we should do about it.

At his press conference last night, though, the President left the impression that he is not part of that consensus; that he will not be a part of the debate; and, most disturbingly, that he does not understand the trade crisis.

When the President of the United States denies that we are a debtor nation 2 days after his own Commerce Department announces that we are, that's a matter of concern to all of us.

When the President says we ran trade deficits for most of the last century and claims this as proof that such deficits are not harmful, it demonstrates only that he doesn't comprehend the difference between a developing nation and a world economic power.

The fact is, the United States had trade surpluses in all but 2 of the 95 years from 1875—when we started to become a world power—up to 1970.

In all but 2 of the 15 years since 1970, we have had trade deficits. This year, for the fourth consecutive year, our trade deficit is going to set a record.

At $150 billion, the record-setting trade deficit for 1985 is gaining on our $210 billion Federal deficit, which is part and parcel of the same problem.

When the President of the United States claims that his economic policies have created more than 8 million jobs over the last 33 months, he leaves out the recession that occurred during the second year of his own administration.

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The fact is that just over 7 million jobs have been added to the American economy since he came into office. That's really not a lot to brag about because over 10 million jobs were added during the 4 years before that.

The fact is that our economy during the first half of this year grew at a sorry rate of barely 1 percent. Economists inside and outside Government said the problem was our trade deficit. That's certainly nothing to brag about. The relationship is a strong one as shown on this chart. It shows what's happened since 1983. Real GNP, the gross national product, has taken a dramatic drop since mid-1984. During that same period of time, the U.S. trade deficit has been going off the chart. The trade deficit has acted like an anchor, dragging growth down.

Hopefully, things are going to perk up in the second half of the year. And there are some helpful signs.

But economists with the JEC note that the trade deficit is reducing economic growth this year by 3 percent. So if we could do away with that deficit—or even reduce it somewhat—we would be seeing better growth in both the first and second half of the year.

Most disturbing of all is not what the trade deficit will do to us in the short run. The long-run effects—and not so long at that—are the most disturbing aspect.

Whether the President believes it or not, we have become a debtor nation. We became one this spring. We have essentially no net foreign savings left to draw on. So every time we buy goods made in foreign countries we have to either pay for them by selling something to a foreign country or we borrow to buy them. And when we hear talk of money coming in to buy our securities and our bonds, those are loans, not Marshall Plan grants from abroad. Those folks overseas expect to be paid back.

Around the first of next year we will become the world's biggest debtor nation. Brazil and Mexico will be pikers by comparison.

Within 5 years, if current trends are allowed to continue, we will owe other countries over $1 trillion. That's like placing a $15,000 mortgage on every family in America. And they will have nothing to show for it.

Our next President is going to be forced very possibly to go hat-in-hand to the international banking community to seek extensions of time to pay our debts. I have no doubt that he will get the loan, but he will have to agree to impose austerity here at home, much the same way that the Presidents of Brazil and Mexico have had to lower standards of living in their countries in return for time to meet their countries' obligations.

I strongly agree with something our President did say at his press conference last night. He said he wants to work with Congress to open foreign markets to U.S. products. And it is vitally important that we work together on that.

I also share his concern about the dangers of protectionism. I've been a free trader all my life. I do not like across-the-board surcharges. I like quotas even less.

But we must accept our trading partners for what they are. We've tried to ferret out their protectionist nontariff barriers. But just about the time you identify and eliminate one or two, six others appear in their stead. We have even gone so far as to sug-

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gest that trade surplus nations boost consumption to raise their standard of living, and save less. But I think that's pretty arrogant to try to tell them what to do. And I think it's pretty naive for us to expect to take that advice.

What we have to do to countries like Japan and others who emulate her protectionism is to put them on notice that the United States cannot afford to continue the kinds of enormous trade deficits we have had since 1982.

How do you force nations to mend their ways? You do it by setting a trade ceiling on nations with a history of barriers to our products and excessive trade surpluses. Specifically, I have introduced legislation that mandates that such nations' sales to us should not exceed our sales to them by more than 65 percent. I think that's pretty generous. I'd welcome the same limitation placed on us. And when that ratio is exceeded, then those trading partners must gradually reduce the surpluses or they're going to face a temporary 25-percent surcharge on all imports to the United States. It's a big stick but we put it in the closet and let them make the choice.

Congressmen Dan Rostenkowski and Richard Gephardt have joined me in sponsoring this legislation. It is titled "The Trade Emergency and Export Promotion Act."

We will all be better off when world trade expands. We set out in this trade expansion legislation to construct a system that will protect our national interest—not by reducing imports—but by giving trading partners of the United States a realistic set of incentives to open up their own markets.

Four countries at present would be affected: Japan, Taiwan, Korea, and Brazil. Now, do you think these countries would retaliate, as some have said, or do you think they would reduce their trade surpluses? They're smart. They're tough and able competitors and they certainly have the judgment and ability to go ahead and reduce their trade surpluses and avoid the 25 percent. Let me assure you that Japan certainly isn't going to run off its No. 1 customer.

This is most assuredly not protectionist legislation. It is the most effective way that has been presented to do what the President wants to do—to break down foreign protectionism and open foreign markets to U.S. products.

I hope the President will join us in supporting this measure. But, given his attitude up to this point, I doubt that is going to happen. So far, what he is proposing with regard to trade is too little and too late. He seems little aware of how pervasive protectionism is abroad.

Now this hearing is going to explore that bill and broader issues raised by protectionism abroad with a very distinguished set of witnesses this morning.

Leading off will be Donald E. Petersen, chairman of the board and chief executive officer of Ford Motor Co. Following him will be a panel composed of Prof. Lester Thurow of MIT and Prof. Paul Davidson of Rutgers.

Mr. Petersen, will you come forward first, please? Mr. Petersen, I know with the responsibilities you have that being here at this

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busy time of the year shows your deep interest and concern. We are most appreciative of that. Will you proceed?

STATEMENT OF DONALD E. PETERSEN, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, FORD MOTOR CO.

Mr. PETERSEN. Mr. Vice Chairman, I appreciate this opportunity to express my thoughts on the U.S. trade deficit.

Many thoughtful people with outstanding credentials are grappling with this problem, and it's clear that the solutions are neither easy nor obvious. But it's also clear that the problem is extremely serious, has national and international implications, and must be tackled. So, I'm pleased to be asked to participate in the debate.

A recent article in the British magazine, the Economist, asked the question: "Is manufacturing un-American?" This gave me pause because it stated so clearly the fundamental dilemma. Over the years, Ford has certainly faced tough competition both here and abroad. We've had experience overseas from time to time making difficult decisions to discontinue or significantly alter our production. But never have we faced such a challenge to successful continued production in the United States, our home base and traditionally the source of the strength. One has only to read the daily papers to see that the threat is not just to Ford, and not just to the auto industry, but to most U.S. manufacturing—from textiles to electronics—and agriculture as well. The public's concern about the loss of jobs to foreign competition is chronicled in ways ranging from opinion polls to popular song lyrics.

This is one issue on which the key facts are not in dispute. The trade deficit is real. The strong dollar is the principal cause of the trade deficit, and the net inflow of capital—attracted, in part, by high real interest rates—is a major contributor to the strength of the dollar. This has been true for a sufficiently prolonged period to be causing permanent damage to our American industrial base.

Nonetheless, some suggest that no action is necessary. They say foreign capital is needed to finance our record Federal budget deficits and, furthermore, that the trade deficit benefits the U.S. economy by holding down inflation, permitting lower consumer prices, and forcing U.S. business to be more competitive. Some economists say that the manufacturing jobs lost to our trading partners represent a false issue because there has been a net increase in U.S. jobs.

There is no question that intensified foreign competition has stimulated American business to get its own house in better order—to improve quality and products, reduce cost, and better utilize its human resources. As they say, it certainly gets your attention and concentrates the mind. I'm proud of the progress we've made thus far at Ford. Even so, cost and product competitiveness is a never-ending challenge that will require our continuing best efforts, and we recognize we have a long way yet to go.

It must be recognized, however, that this intensified foreign competition reflects a substantial artificial advantage in manufacturing costs caused by the strong dollar. This advantage is unrelated to technology, efficiency, or productivity—the factors that normally

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determine competitiveness. The net result is a loss of sales to foreign manufacturers, followed by a loss of U.S. production and jobs, and, finally, a trend for many companies in affected industries to shift production overseas. This uprooting of manufacturing investment affects not only the production of primary products but the supplier and service networks as well. It directly affects U.S. employment; in many ways, U.S. workers are innocent victims of the U.S. trade problem. It is estimated that the trade deficit has cost nearly two million jobs in U.S. manufacturing in the last 5 years, and it is likely that most of these job losses will not be recovered.

Few favor permanent trade restrictions to overcome trade distortions; certainly we do not. The specter of Smoot-Hartley frightens all of us, and everyone agrees that the world is well-served by open economies in which fair competition can thrive without distortions. But today's trade and exchange-rate imbalances are so large that they threaten the entire system if no action is taken.

The problems we need to be working on are clear, even if all of the specific solutions are not at hand. There are some problems the United States can resolve by itself, some on which we need the cooperation of our trading partners, and others where the goal must be to avoid making things worse.

First, the most urgent priority is for the United States to cut the Federal budget deficit. This should put downward pressure on interest rates, which will benefit the domestic economic climate. Equally important, budget reductions will improve our international competitiveness and trade position by reducing the demand for foreign capital, thereby leading to a more competitive exchange rate for the dollar.

Second, the United States must continue to insist on improved access to oversea markets for U.S. products—equal to the access we accord our trading partners. It's not enough to rely on technology and innovation to keep us ahead. Some of our trading partners have kept their markets closed as long as the United States had the lead in a specific technology, and opened them only when the local industry was judged ready to compete. For the past 5 years, the administration has made market access a top priority, undertaking, for example, a series of market-opening negotiations with Japan. Now President Reagan and Ambassador Yeutter have announced that the administration will take action on selected products where our trading partners have been particularly obstructive. These initiatives will help.

It seems to me that there is a difference in cultural perspective that makes these negotiations all the more difficult. We use the same words, but they seem to mean different things to the two sides because of our differing views of the problems and objectives. Beyond that, there is a mindset, not only in Japan but in other Pacific Basin countries, that what is good for their own economies far outweighs other considerations. So, they slow-walk us in negotiations, and progress is measured in inches.

Third, the United States and our trading partners must take action on exchange rate imbalances. Earlier this year, Treasury Secretary Baker proposed multilateral monetary talks in conjunction with a new round of trade negotiations. Such discussions should address growth in international capital flows and identify

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ways to minimize resulting distortions in exchange rates. I hope the administration and our trading partners will put monetary discussions at the top of the international economic agenda.

Fourth, our trading partners should take appropriate action within their own economies. Europe's reliance on exports and lack of domestic growth and the even more export-driven orientation of Japan and the newly industrialized countries are contributing to the United States trade problem. Knowledgeable Europeans have called on their countries to undertake policy changes to encourage investment and domestic growth. Similarly, Liberal Democratic Party leader Kiichi Miyazawa said in his recent visit to the United States that Japan must now emphasize housing and other domestic programs that will improve the Japanese quality of life. Mr. Miyazawa pointed out that investing more money at home would stimulate economic growth, attract more imports and reduce capital outflows, thus ultimately strengthening the yen.

There are other problems that require the attention of the world trade community, such as how to help the less developed countries—which are carrying heavy debt burdens—to participate more fully in international trade. The United States cannot be expected to continue to absorb the lion's share of the exports these countries need to handle their debt. Our major trading partners must take a greater share of this responsibility.

Finally, the United States must try to avoid taking actions that reduce the competitiveness of American industry. Regulatory programs should achieve their goals without impairing the ability of U.S. industry to compete internationally. Fuel economy standards are a case in point. Modifications are necessary to avoid reducing the ability of the home industry to compete. And as to tax reform, Ford supports a simpler and fairer tax structure, but I am concerned that some of the proposed changes place a substantial burden on capital-intensive companies facing tough international competition. In fact, only recently have this country's incentives for capital formation become competitive with those of our trading partners.

The solutions to these basic problems require putting aside some old ideas, developing creative and constructive alternatives, and setting in motion new programs that involve major policy changes. We must tackle them on an urgent basis. But even with the most aggressive action plan, results will take time.

Meanwhile, the United States is losing jobs and production. And by their very nature, decisions to close plants or to shift production abroad are likely to be permanent—not easily reversible if and when exchange rate and trade conditions change. These are long-term consequences of what we hope will prove to be temporary trade problems.

What, then, must we do in the short term? How do we prevent permanent losses while we all work together to put effective long-term solution in place?

In my view, we need prompt action that will yield significiant short-term results. The trade legislation you have proposed, Senator, recognizes that repeated U.S. initiatives aimed at opening foreign markets have not cured the U.S. trade imbalance. Your bill is a realistic, results-oriented approach to the problem.

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It focuses on those few countries that have extraordinary trade surpluses that are engaging in restrictive trade practices.

It would apply a surcharge only if the deficits are not reduced and the barriers to U.S. products are not removed.

It would not erect permanent trade barriers, but would induce countries with large trade surpluses to take actions on their own to reduce those surpluses. It tells the countries to deal with the problem however they might wish—it doesn't get into the specifics, but makes it clear that they must solve the problem and that the United States has the will to act if they do not. This language is certain to be understood.

All in all, I believe it's a constructive approach to the immediate problem. We commend your leadership, Senator, in taking this initiative. It already has helped stimulate needed debate and focused national attention on this serious national problem.

Senator BENTSEN. Mr. Petersen, I think that's an excellent statement and certainly a thoughtful one. It will be helpful. I must say, it sounded a lot like some of the things I've gone through in seeking a way to move a world that has a great deal of managed trade and a lot of state-directed trade back to free trade once again.

Yet we're faced with 30-second spots trying to cover this issue. These folks over here, these television cameras, have quite a challenge on their hands in trying to make people understand the concerns of world trade in 30 seconds. I listened to the President last night, he seems to say we just have two options: that we have a situation where we don't do anything about protectionism abroad or we resort to total protectionism here. His position is wrong and I hope he changes it soon and begins pushing for trade which is both free and fair.

There obviously are options in between as we try to restore some reasonable balance in trade.

Free trade to me presupposes that you're going to have some reasonable balance in trade. Without that, I don't see how we can have a continuous drain of the wealth of this country without finally hurting the standard of living of our people.

How do you think we can make the public more aware of the problem and the seriousness of this trade deficit?

Mr. PETERSEN. I think perhaps, Senator, one of the finest things that is happening in America today is that there is real concentration on this problem for the first time.

Earlier this summer I spoke to the Midwest Governors Conference and my plea with them was that they, as Governors of 13 States severely hurt by the trade deficit, join with industry in a common effort to try to emphasize the importance of this problem and to help elevate it in terms of its priority among our many very serious problems that we have to face in this country.

So I personally hope that we all can avoid the extreme adjectives as we discuss a subject that is certainly one that draws such adjectives like flies, and reason together, because I truly think we should be all as Americans seriously concerned about the issue.

So the dialog that's going on is certainly a big help.

Senator BENTSEN. I guess that's out of the Book of Isaiah, "We come to reason together."

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I'm not a protectionist, but I'm not a pushover either. And I think you have to find ways to break open these markets.

Would you explain to us some of the problems that your company, for example, has with foreign trade barriers to selling Fords?

Mr. PETERSEN. Are you referring, Senator, to the problems we're having as we do business in——

Senator BENTSEN. As you conduct business in other countries, what kind of barriers do you run into?

Mr. PETERSEN. An example would be in the Common Market in Europe where legislation will be passed by the EEC in effect placing on industry the sole responsibility for attempting to have, let's say, an equal price in all of the markets of Europe. This ignores all the other dynamics that can dramatically affect costs in the various countries of Europe. And this, in turn, can create some very difficult problems as far as just where should we position ourselves in those various countries and how can we truly function as part of a common market. That would be one illustration.

In South America today, I'd say that the major problem that we face is one in which the countries attempting to cope with their massive inflation resort to price controls that place us in very, very serious loss positions.

Senator BENTSEN. Now would those same countries have those kind of problems trying to sell here?

Mr. PETERSEN. The flow to date has been very favorable certainly for developing countries such as Brazil and Argentina. As Brazil, for example, is one of the countries that could be affected if the bill were enacted as presently drafted, this could be an area where temporarily a company such as Ford might be hurt some. But I think in the larger need of working toward improved balance of trade, that's something that we would have to find a way to live with.

I also think there's a chance or a possibility that we might see ways where developing countries with extremely serious problems could be accommodated.

Senator BENTSEN. Thank you, Mr. Petersen. I see that my time has expired. We are very pleased to welcome Congressman Scheuer here from New York, a very valuable member of this committee.

I'd like to now turn to Congresswoman Fiedler, if you would proceed with your questioning.

Representative FIEDLER. Thank you very much. I was wondering if you could tell me whether you think IMF investment is creating any competitive problems for you in, say, South America or in other places?

Mr. PETERSEN. The general approach to investment—my sense of it is that there are other governments around the world that provide more incentives for foreign investment than does the United States.

Representative FIEDLER. I guess my question is, Are we asking American taxpayers to invest in other countries, and is that investment then coming back and biting us in the backside because those countries are competing with our own industries, and is your industry one of those industries?

Mr. PETERSEN. So much of the investment that American firms—certainly an automotive firm, speaking for Ford—that we've made

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overseas has been made to participate in the markets overseas. So that if you take Ford as an illustration, we now are a major manufacturer in I believe it's 19 or 20 countries around the world, and in each case, our primary thrust is to participate in that economy because we believe if we want to be a significant factor in a market we should also be a supplier of jobs.

So that export of investment, that investment, if you will, by us, is fundamentally operative in that market, not in creating massive flows back to this country. We still run, for example, North America content in our North American automobiles well over 90 percent, probably 92 or 93 percent.

Representative FIEDLER. Has the investment tax credit and the accelerated cost recovery system had an impact whatsoever in making your industry more competitive here in this country?

Mr. PETERSEN. What happened in 1981 was extremely helpful. Indeed, it very clearly helped us make the major investments. We invested billions of dollars while we were losing billions of dollars and it helped us greatly to make those very investments in new products and new facilities that permitted us to achieve the improvements in our competitiveness.

Representative FIEDLER. Would you say that the elimination of the accelerated cost recovery system or the investment tax credit would have a significant negative impact on reinvestment here in this country?

Mr. PETERSEN. Yes, ma'am, I definitely believe that.

Representative FIEDLER. Could you tell me how much help the President's Voluntary Restraint Agreement with the Japanese Government was in limiting Japanese automobile imports, and what kind of an impact it had on your ability to gain a competitive edge here.

Mr. PETERSEN. It was enormously helpful. The auto industry clearly had a major restructuring to be done that was unique to the U.S. auto industry because we were the only country that had a complete resizing, if you will, of our products that we had to undertake. Therefore, it was very, very helpful.

In addition, during that span of time, we have been living with a relationship between the dollar and other currencies that has seriously eroded our ability to be competitive and, to us, one of the primary reasons we didn't think it should be removed earlier this year. At the very time it was eliminated I believe the dollar had reached essentially an all time high level in terms of its relative exchange with foreign currencies, especially the yen, which clearly suggested that we were in a position where we were carrying a very heavy burden that we couldn't do a thing about.

Representative FIEDLER. You made one comment earlier about renegotiating the exchange rate with other countries. It seems to me—and I'd like you to point out where the fallacy might be in my thinking—that that is merely an artificial adjustment.

Unless we keep our deficits down—how will that really help?

Mr. PETERSEN. Well, first, let me share with you the fact that I don't consider myself a real professional student of this issue, but I am of the mind that financial flows are a new phenomenon that is ill-understood and has a very significant impact on the trade balance and on the value of the dollar.

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Representative FIEDLER. But doesn't that financial flow reflect the fact that people in other countries are investing in the United States because it's a good investment compared to other more sluggish economies. And so trying to negotiate some type of an artificial change, without having the substantive economic improvements, won't really have a significant impact?

Mr. PETERSEN. In an earlier speech that I made I indicated that it seemed to me this is an issue where we ought to draw on some of the best minds in this country to see what suggestions they might have about what could be done about this tremendous imbalance and this tremendous net inflow of capital into this country, because it is a very new phenomenon. It's very dangerous one it seems to us because it can be changed virtually overnight with all the electronic transmission capabilities in financial flows.

We would like to think something fundamental could be done if we would address ourselves directly to this problem and deal with it without waiting for the fundamentals of the Federal budget deficit and some of the other factors to which you've alluded to be worked on and improved.

Representative FIEDLER. Thank you very much.

Senator BENTSEN. Thank you very much, Congresswoman Fiedler.

We're very pleased to have Congresswoman Snowe here. Please ask such questions as you desire.

Representative SNOWE. Thank you, Senator, and I thank you, Mr. Petersen, for your testimony here today.

Do you think it would be a major failure of this Congress not to enact any legislation regarding our trade problem such as the Senator's bill to impose a surcharge on imports?

Mr. PETERSEN. If I could answer somewhat more broadly, I'd like to say it would be a major failure of the United States if we don't take some strong action to improve our far too excessive imbalance of trade.

That could be done a variety of ways. Certainly, as I've said in my testimony, it seems to me that the bill that's been proposed by Senator Bentsen is a very well-conceived approach to this, but I think other approaches could be taken, too.

Representative SNOWE. You mentioned the Smoot-Hawley Act and many have said that we could sort of draw a parallel if we should enact the legislation such as imposing a surcharge.

Do you have those same concerns, that we could experience the aftermath of the Smoot-Hawley Act if we were to pass such legislation here in the Congress?

Mr. PETERSEN. I think we have to remember just how different the circumstances are and the conditions. The Smoot-Hawley Act applied tariffs averaging just over 60 percent on all trade. Today, we have tariffs averaging a little over 4 percent. And if the bill that's being proposed and being discussed works the way you would like it to work, you would never see surcharges because the affected countries would take appropriate action. Even if there were, they would apply to only a small percent of trade.

So it seems to me there's just a gross difference in terms of the effect on world trade in real or potential sense that would be affected.

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Representative SNOWE. You believe, then, that the surcharge legislation would be an incentive for our trading partners?

Mr. PETERSEN. Yes, ma'am.

Representative SNOWE. You do?

Mr. PETERSEN. I do believe that is the good aspect of the way this proposal has been written.

Representative SNOWE. Do you have any concerns that they might retaliate, as some have suggested?

Mr. PETERSEN. I think we always should be concerned about whether that might happen. I wouldn't want to set it aside without considering it seriously. But our market is just fundamentally important to the other countries in the world and if you take, for example, the worldwide auto market, there isn't a country in the world auto industry that isn't making the preponderance of its profits in the American market, if not all of its profits. Now it's hard for me to believe someone would deliberately walk away from a market such as that.

Representative SNOWE. What action do you consider to be the most important in reducing the deficit?

Mr. PETERSEN. The trade deficit?

Representative SNOWE. No, the budget deficit.

Mr. PETERSEN. The budget deficit. I think it has to be a continued drive on the spending side and to me it has to be as across-the-board as it possibly can be. Certainly, the one exemption we all believe should be made would be anything affecting the poor. But I think, beyond that, the pain better be shared everywhere, it needs to be shared everywhere.

Representative SNOWE. Finally, do you think if we were to pass legislation like the surcharge bill or something closely approximately that, it would strengthen or weaken our negotiating position in a new round of GATT talks?

Mr. PETERSEN. I should think it would strengthen our position because we would be seen to have come to the conclusion that we must take some actions to support our own interests and that we would be seen to have the will, if you will, to be certain that those interests are served at the same time that we work with other countries to improve worldwide trade.

Representative SNOWE. Well, I thank you, Mr. Petersen, for offering your perspective here today in what is obviously a very important issue for the Congress and certainly for me as a Representative from a State that has had a number of trade-related problems in the last 7 years since I've been representing a district in Maine. So I'm hoping that Congress will take some action on trade policy. Thank you.

Mr. PETERSEN. Thank you.

Senator BENTSEN. Thank you very much, Congresswoman Snowe.

I'd like now to turn to Congressman Scheuer to make such comments or questions as he desires.

Representative SCHEUER. Thank you, Senator. I have enjoyed your remarks very much, Mr. Petersen.

Mr. PETERSEN. Thank you.

Representative SCHEUER. I recall just a moment ago when you were asked what we should do about the deficit you said, "Cut spending, but don't hurt the poor." Well, there's not very much

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left, if you analyze it. If you can give me some specifics on spending cuts that we should make without hurting the poor, I'd be grateful for that.

I'd also like to know—you have something that I ain't got—in fact, you've got a lot of things that I ain't got. But first and foremost among them is terrific, continuing, systematic access to our President.

When you see our President, what do you tell him about the need for restoring some of those tax cuts that we made in the beginning of his administration? At a time when we're running a $20 billion a month deficit, $240 or $250 billion a year, what do you tell him about the general intelligence of a tax reform bill that's revenue neutral? What do you tell him about the need to get our defense budget under control, the defense procurement process under control?

Can you enlighten us on some of those things? That's one thing that you have that most of us in this room don't have.

Mr. PETERSEN. You asked first about the Federal deficit. It seems to me unless actions are taken in those areas where the great bulk of our Federal funds are spent, the effort really is hopeless.

Representative SCHEUER. You're talking about entitlements?

Mr. PETERSEN. Therefore, I'm talking about entitlements. I'm talking about defense. If you exempt those two, you really are working uphill, it seems to me.

Representative SCHEUER. Right.

Mr. PETERSEN. As far as what does Ford attempt to say to this administration, we indicate that we are certainly in favor of the idea of simplifying our tax structure, but that in so doing we think it would have a very serious negative impact on the trade situation if we were to take some of the steps that would once again make our capital-intensive industries less competitive in world trade. Some of those elements are there.

Representative SCHEUER. How about a possible minimum tax on corporations? I'm talking about the $100 million corporations—corporations showing profit of hundreds of millions of dollars and paying little or no taxes. I'm talking about individuals who make up in six figures and pay virtually no taxes, as thousands of them are doing. I think the American people don't want taxes for middle income people raised, but I think they sense a certain unfairness about the opportunities for tax avoidance—and I say that purposefully—it's not tax evasion. Corporations and individuals have very talented accountants and lawyers who take advantage of legitimate opportunities for reducing their tax obligations through these various provisoins in the tax law.

How do you react to idea of a minimum corporate tax in the nature of 25 percent, let us say, maintaining the incentives for investing, and a significant minimum tax on individuals making upwards of $100,000?

Mr. PETERSEN. I'll answer your question, sir. Let me say first, however, that I hope my answer doesn't become the only comment that comes out of these hearings because one of the difficulties I think we have today is that talking tax reform is a subject that everyone can get all engaged in and it permits us all to walk away

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from the mega-issues, which are the Federal deficit and the trade deficit.

Representative SCHEUER. What I'm asking you is, isn't tax reform directly connected with the Federal deficit, if we forget this shibboleth that the tax reform bill must be revenue neutral? Can't tax reform make a major contribution to eating away at that Federal deficit?

Mr. PETERSEN. I share the reluctance that I sense in many others to say much about tax increases at this stage because I think it's so vital that we cut spending and that we keep all of our attention on cutting spending.

Now as to a minimum tax, it seems to me there's some real merit, if I can make that one response to you.

Representative SCHEUER. On both individuals and corporations?

Mr. PETERSEN. Yes, sir. I'd be happy to tell you, if you'd like to know my percentage that I pay personally, I'll be happy to tell you after these hearings.

Representative SCHEUER. That will be one way for us to figure out whether you have a competent tax counsel or not. [Laughter.]

Mr. PETERSEN. I guess on that basis my counsel is pretty incompetent, sir.

Representative SCHEUER. Thank you, Senator.

Senator BENTSEN. Thank you very much, Congressman.

A recent review of 40 studies found that there are 28 ways governments intervene in trade. The Japanese utilize 25 of them and the United States uses six. So when we talk about our concerns for Smoot-Hawley, I think it's alive and well but it's in Japan.

Mr. Petersen, we're very pleased to have you. I think you've made a major contribution, and we're very appreciative of your being here.

Mr. PETERSEN. It's been an honor to be here. Thank you all very much.

Senator BENTSEN. Thank you.

Now our next two witnesses are Prof. Lester Thurow and Mr. Paul Davidson. Lester Thurow has been in the forefront of this fight for some time with some creative and innovative approaches to the problem. We're delighted to have him here.

Mr. Paul Davidson is an outstanding professor of economics at Rutgers University of New Jersey. We're very pleased to have you both. Mr. Thurow, would you proceed first?

STATEMENT OF LESTER C. THUROW, PROFESSOR OF ECONOMICS AND MANAGEMENT, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Mr. THUROW. The U.S. Congress should take action to control 1985's looming $160 billion trade deficit.

Such deficits lead to international indebtedness. America is plunging into debt at a rate that makes the Brazils of the world seem positively prudent by comparison. At the end of 1982 the United States had net foreign assets of $147 billion. On about the first of May, it became a net debtor nation for the first time since World War I. That fact should have sent out a mayday signal to every American. Early in 1986 it will pass Brazil to become the

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world's largest net debtor. At some point those debts will have to be repaid and when this happens the United States will be forced to undergo austerity in exactly the same sense that Mexico is now undergoing austerity. It is far better to prevent such debts than to repay them after they have been incurred.

Such deficits destroy both firms and jobs. American industry is being crushed by the high valued dollar and the resulting trade deficit. The firms being driven out of business are not the dregs of American industry but some of its finest specimens such as the Caterpillar Corp. and the semiconductor industry. A trade deficit of $160 billion represents the loss of about 4 million jobs. Much of what is now being lost will never be regained. It is far better to prevent such industrial disasters than to have to clean up the mess after it has occurred.

Before going on to spell out what must be done let me closely analyze the standard argument—the President's argument—for doing nothing. The standard argument goes as follows: If the rest of the world is running a trade surplus with the United States it is accumulating dollars. If the rest of the world never spends those dollars, Americans are clearly better off since they get real goods and services in exchange for green pieces of paper. If, as is more likely, the rest of the world doesn't want to give us real goods and services in exchange for green pieces of paper, it will eventually have to use its accumulation of dollars to buy something from the United States and Americans will regain the jobs that they previously lost. In the meantime, the average American consumer will have a higher standard of living because of cheap imports.

This argument is not wrong, it is correct, but it fails to mention a lot of equally true propositions that are part and parcel of the previous argument.

A trade deficit produces a higher aggregate American standard of living but it produces both income gains and losses among Americans. Those who lose their jobs to foreign competition are unambiguously worse off even though those who remain employed will in the aggregate make larger real income gains from lower consumer prices. The net result will be a higher average real income but a more unequal distribution of income around that average.

A trade deficit produces a higher average income today, but it also produces a lower average real income in the future when international debts are repaid. If foreigners decide to cash in their dollars and buy American goods and services, Americans will be forced to reduce their own standards of living in the future to provide the necessary goods and services for foreign markets. But as is more likely, foreigners may also decide not to buy more American goods and services but, instead, to insist—by refusing to extend new loans or rollover old loans—that Americans cut back on imports to produce the trade surplus necessary to repay debt. America's debts are repaid not by raising American exports but by reducing American imports. This is the medicine prescribed for Mexico—its average per capita income has fallen 9 percent—and there is little reason to believe that the world will prescribe a less painful medicine for the United States.

In the standard models used to analyze international trade no one worries about the loss of jobs or firms due to overvalued cur-

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rencies. First, persistent trade surpluses or deficits are impossible in the model—a point to which I will return later; second, such deficits can produce no long-run harm; and third, the economy is assumed to operate without unemployment. No long-run harm can occur since the models assume there are no transition costs—it costs nothing to go in or out of business—and that everything is reversible—if a firm goes out of business because the value of the dollar is too high it will come back into business when the value of the dollar falls. Workers who lose jobs in exporting or import competing industries quickly find alternative work in other industries because free market economy always operate at full employment in the models.

But reality is marked by very large transition costs, lots of irreversibilities, and persistent unemployment. Given severance pay, early retirements, and low prices for used machinery, the costs of going out of business can be enormous. Given the need to acquire and train a labor force and to develop distribution and marketing networks, the costs of getting back into business are even larger. Once a market position is lost and customers have developed relationships with foreign suppliers, it can be virtually impossible to get back into business. In the American economy persistent high unemployment has now been a fact of life for a very long time.

As a result countries have to worry about the long-run industrial costs of intermediate-run overvaluations of their currency. Unless one believes that a country can forever go into debt the overvalued dollar problem will eventually cure itself, but there are substantial costs to simply letting events run their normal course. The firms and jobs regained when the dollar falls may well be in much less productive industries than the firms and jobs lost when the dollar rose.

If one wants to see the long-run effects of an overvalued currency, one need only look at the industrial demise of Great Britain. In 75 years it has gone from being a country with the world's highest productivity to being a country that now ranks near the bottom of the league of industrial countries. Much of the blame can be ascribed to policies which kept the pound high and systematically made it impossible for British industry to compete at home or abroad.

The economic models that say that we should not worry about the balance of trade deficit also say that what does in fact exist (a very large persistent deficit) cannot exist. The value of the dollar is supposed to adjust to maintain an approximate balance between exports and imports over relative short periods of time. As a result governments do not need to have explicit adjustment policies. But empirically this hasn't happened. The value of the dollar rose until early 1985 despite the fact that the United States was generating ever larger trade deficits.

To explain this conflict between theory and reality, economists point to the development of world capital markets. In today's integrated capital markets the value of the dollar is determined by capital flows and not by trade flows. If people want to move their money into the United States because of high interest rates, the value of the dollar will rise no matter how large the trade deficits. One need not believe this proposition in the very long run (it

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cannot be true unless the rest of the world is willing to lend ever large sums to an ever deeper indebted United States forever) to believe it in the short and intermediate run.

I believe that the U.S. Government should and could intervene in world currency markets to lower the value of the dollar, but there are those who argue that there is now so much private money in those markets that governments have lost their ability to control currency values. The only way to determine whether this argument is true or false is to attempt a massive intervention and see what happens. I suspect that there are not many private currency speculators that want to bet against a market player with an unlimited supply of dollars (the U.S. Government) who is determined to get its balance of payments under control, but no one knows for sure.

But if you believe the currency interventions are impossible or undesirable and that currencies no longer adjust to balance trade flows in the short and intermediate run, then a country must develop alternative public policies for maintaining a balance between exports and imports if it does not want to fall ever deeper into debt and destroy its industrial base.

In designing a cure it is important to build an instrument that will expand rather than contract world trade. To do this the instrument must place the pressure for adjustment on countries with surpluses in their balances of payments. If surplus countries adjust by raising their imports, the volume of world trade expands and the world economy grows. If deficit countries must do all the adjusting, they can only do so by reducing their imports and this leads to a contraction in world trade and a stagnant world economy.

Put all of these considerations together and America needs something like the recent Bentsen-Rostenkowski-Gephardt proposal. A relatively large import surcharge should be levied on the imports of countries that have large persistent surpluses in their overall account balances.

This proposal has been roundly denounced as simple protectionism, but it isn't. The purpose of the bill is not to impose an import surtax but to force countries to reduce their surpluses. If the act worked perfectly, the tax would not be levied on anyone since each surplus country would have taken effective measures to eliminate its surplus by expanding its imports.

To describe the Bentsen-Rostenkowski-Gephardt proposal as simple protectionism would be to describe drunk driving laws as bills for simply putting people in jail. The purpose is not to put people in jail but to encourage (force) good behavior. Those who do not drink and who do not run large trade surpluses are not put in jail and do not have to pay the import surcharges.

One can argue about the details of the Bentsen-Rostenkowski-Gephardt proposal, but something like it is needed if the United States is not to sink ever deeper into debt, if it is to preserve its industrial base, and if the world economy is to expand rather than contract.

I would suggest the following specific changes in what has been proposed.

First, to demonstrate to the rest of the world that the act is not a simple American retreat into protectionism, all specific tariffs and

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quotas on individual products would be removed when the more general act went into place. An across-the-board tariff that can be eliminated by any country that chooses to get its own house in order is much less protectionist than the current policy of gradually expanding individual product restrictions.

Second, the surtax should be triggered not by some measure of bilateral trade between the United States and any other country but by persistent large surpluses in a country's current account balance. This automatically eliminates the problems presented by a country like Brazil that must run large trade surpluses to repay foreign lending. Interest payments are part of the current account and an automatic offset to trade surpluses.

Third, there is no longer any reason to exempt the oil exporting countries from such provisions. At one time they did not have the physical infrastructure (ports, roads, skilled people) to spend their export earnings but those days are long gone.

A modified Bentsen-Rostenkowski-Gephardt proposal would be a positive step for enlarging world trade, keeping the United States out of debt, and preserving America's farm and industrial base.

Senator BENTSEN. Thank you very much, Mr. Thurow.

We will hold questions until both the witnesses have testified. Mr. Davidson, we're very pleased to have you here. Would you proceed?

STATEMENT OF PAUL DAVIDSON, PROFESSOR OF ECONOMICS, RUTGERS, THE STATE UNIVERSITY OF NEW JERSEY

Mr. DAVIDSON. Thank you. I have a 12-page prepared statement. I will not read it, but I will summarize merely the points.

First of all, I think the argument of free trade versus protectionism is really not the proper analytical background for this discussion and until we get our analytical framework right we're unlikely to get our policy right. Therefore, I thank the committee for giving me this opportunity to explain why I believe the Trade Emergency and Export Promotion Act is an important positive step.

Free trade is not a goal in itself. It is merely a means to an end which requires certain preconditions. These are full employment of the trading partners and a balance of trade so that there are no cash-flow problems. Without those preconditions, free trade can really be more of a problem and I point out to you that those people who are arguing free trade no matter what, are the same people who 12 years ago argued that if we left the exchange rate to a free market we would have no balance of trade problems whatsoever. Well, we did leave the exchange rate to a free market and we see that that kind of thing doesn't automatically adjust itself in market processes.

The only other response would be, "Well, in the long run it will work," but, of course, the famous statement about in the long run we'll all be dead, I think, is particularly apropos here.

Free trade cannot be an overriding guiding principle in the absence of full employment, particularly if large trade deficits occur. One person's trade deficit is obviously some other nation's surplus.

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Under the rules of the game, it is only the deficit nations that usually have to make the adjustment and this is a tough thing. In cases where the IMF gets involved, what they suggest is that the country be squeezed, that the economy be squeezed, that they reduce their real income and by reducing their real income reduce their demands for all goods and services, including imports. The effect, of course, is not only to hurt the deficit nation, but all surplus nations because when they reduce imports, global employment, output, wage, and profit income will all be lower than otherwise.

The intelligent adjustment for a trade deficit should not be solely on the basis of forcing the deficit country to make the adjustment, particularly as long as there are unemployed resources in both nations. If we can make an adjustment where output will expand in both countries, then the adjustment will lead to a higher real income of both nations.

History has provided us with examples where the surplus nation has acted unilaterally to reduce the surplus and has led to improved economic well-being for all nations. After the Second World War the United States necessarily ran huge trade surpluses with its trading partners around the world. But instead of allowing these surpluses to be converted into a piling up of liquid claims against the deficit nations which would have impoverished the deficit nations and led to political unrest in Europe and Asia, the United States redistributed much of these potential surpluses via the Marshall Plan and other foreign aid programs.

The result was not only to improve the economic standard of living of residents of the war-torn deficit nations and to help them rebuild their economy until they have now become strong, viable international competitors, but also by giving the foreigners these surplus funds they were able to buy more American products and thus stimulate employment and prosperity in the United States.

Had the United States forced the trade deficit nations to make the entire adjustment after World War II by tightening their belts, by reducing their exchange rates, by limiting their imports, the result would have been global impoverishment, depression, and probably political revolution.

The U.S. experience after the Second World War shows that mere reliance on free trade and not intelligent adjustment to the situation need not be the proper or optimal outcome.

The post-World War II trade surpluses gave our Nation the opportunity to improve global well-being and forced the economic growth and democratic capitalism in Europe and Japan, but we did it from a surplus country standpoint at that point.

The huge trade deficit currently being run by the United States can provide us with another opportunity to reestablish, this time from the position of a trade deficit nation, the principle of fostering adjustments by both surplus and deficit nations in conditions of less than global full employment.

If properly understood and developed, such policies of cooperative action to improve economic well-being can lead to a more stable and better political and economic life for capitalist nations around the world. And I believe the Emergency and Export Promotion Act provides such a pragmatic approach to induce surplus nations to

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cooperate and take positive actions to improve the current trade imbalance and improve real living standards.

A little historical perspective might be useful. Since the 1970's, as the Senator has already pointed out, we've had a merchandise trade deficit in almost every year, and this is true, but the deficit of exports versus imports when we use goods and services as a basis of comparison has tended to be positive in most years, at least until 1982.

It was only after the recovery in 1982 that the larger export-import balance, including services, turned negative and turned dramatically negative.

Now what caused this? Well, some people say the over-valued dollar makes our industries noncompetitive with the rest of the world. I would point out to you that ever since 1973 the dollar has been high, the dollar has been low, the dollar has been in the middle; nevertheless, our export surplus including services has been positive in every year since the breakdown of Bretton-Woods—in almost every year, except for the last 2 years. So it wasn't the dollar valuation by itself—overvaluation or undervaluation—which was creating the trade or I should say the net export problem.

The dollar declined by more than 10 percent from its 1973 value as Secretary of the Treasury Blumenthal talked down the dollar in order to expand exports. By late 1978, the dollar had declined so much that the United States—and here I pick up a point that Professor Thurow had pointed out—in 1978, in cooperation with other major nations instituted the largest intervention package in history to stabilize the value of the dollar. It worked. So it is possible, with cooperative actions on the part of central banks to stablize against the private market even with these large sums of money.

It remained steady at this new level set in 1978 until 1980. By 1981, the dollar had surpassed its 1973 peak, and by mid-1982 it was 20 percent above its 1973 peak and yet we were still running a surplus on our net export accounts, the net exports account including goods and services.

The export account surplus only disappeared starting in late 1982 and it turned negative in 1983. The reason was, of course, in 1982 we came out of the world's greatest depression since the 1930's and as the American economy picked up incomes rose and Americans bought more goods, including imports. Thus, the primary cause of the huge merchandise deficit and net export deficit is really, in my view, the fact that the United States has grown more rapidly than the rest of the world and, therefore, we are spending more on foreign goods.

We have not, despite the Reagan recovery—and I point out that Mr. Reagan is the greatest Keynesian in the White House since F.D.R., having given us large deficits and stimulated the country since 1982, we have not created the lower unemployment rate in the United States that we would have in earlier years with such huge deficits, and part of the reason is that the United States is a much more open economy than it was 10 or 20 years ago. Therefore, a lot of this stimulus of demand has leaked out and created jobs overseas We are now at 6.9 percent unemployment which is still relatively high compared to the Carter years.

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Now the current unemployment rate combined with the high trade deficit lead some to demand protective tariffs. But what I wish to argue is that what you need is a trade policy to induce surplus nations to spend more on U.S. goods and services.

I think either protective tariffs or the so-called soft landing for the dollar will not resolve our problem. Those who believe in free trade say, well, the market will take care of this; all we have to do is have the dollar go down by 20 percent and they recognize they don't want it tomorrow, so slowly go down by 20 percent; and that will lead to imports becoming more expensive and exports becoming cheaper and, therefore, the United States will get into a better trade balance.

I argue in my prepared statement that this will not occur and I will explain in a moment why. I think what we want to do is reduce the trade imbalance while stimulating real aggregate income and consumption, and that requires a more innovative approach and I believe this bill is a step in that kind of approach.

I should point out finally, without discussing the point in detail, that the high dollar is partly because of our unique position as the de facto international central banker and that we haven't had the pressure that other countries that run huge trade deficits would have to adjust because we are the central banker of the world.

Moreover, I would say that while the deficit is not unsustainable for a short period of time, it even has some very desirable effects, it does create problems and that's what we have to resolve. We shouldn't forget what the desirable effects, however, of the current trade deficit has been. And that has been we've been acting as the engine of growth for Europe and Japan. Since 1982, because we have expanded, we have led the European countries out of the recession that they have had. If it wasn't for our markets and the growth of our markets, the Eurpean countries and Japan would be mired in a great recession and we might have a world depression.

I have just come back from Europe and I note that in many European countries, the under-24 labor force is more than 25 percent unemployed. This is even in their high level. If the United States wasn't such a great buyer from the EEC, the unemployment rate among this young group would even be greater because of the unemployment, because of the way their economies work, are concentrated on these young groups, and I would expect political unrest in Western Europe to even be greater.

So I think that the trade deficit has done some good, although it's really our imports that have done good, not necessarily the deficit by itself.

The trade deficit does create problems of liquidity and here I hope that section 103 of the Trade Emergency and Export Promotion Act would be interpreted as supporting an international institutional arrangement for reestablishing some sort of Bretton-Woods type arrangement for regulating exchange rates. I believe that that section of the act by itself is an important and often underlooked part of the act and I think Professor Thurow's suggestion for this would also fall under this same section of the act.

Finally, I want to talk about the other section of the act and the standby tariff. But before doing that, let me point out why I believe

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that a reduction in the dollar will not really solve our merchandise trade imbalance.

If you look at the trade imbalance, which is roughly $150 billion, more than half of the trade imbalance results from trading with nonoil exporting Latin American and Asian countries whose currency is tied to the U.S. dollar. That's $22 billion deficit. Plus oil imports of $55 billion, whose price is also fixed in dollars. Therefore, devaluation of the dollar will not affect that 77 billion dollars worth of trade one iota. They will all move together and there would be no relative price change.

I don't think you can do it with grains, as I pointed out, because the grain importers are husbanding their dollars and so that won't do it.

So my conclusion is ultimately that we ought to have (a) a tax on imported oil against OPEC. I won't argue why, but I think it's important that we have a differential oil tax to try and break the OPEC cartel which now shows good signs of cracking. And second, we have to have any method which will increase the pressure on surplus countries to buy more American goods and I believe that sections 201 and 202 of the act are those kind of sections which encourage surplus countries to buy more to get the trade balance into adjustment by encouraging growth in world demand and particularly growth in products of our industries by surplus countries.

[The prepared statement of Mr. Davidson follows:]

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PREPARED STATEMENT OF PAUL DAVIDSON

Forecast Summary

Table 9
Data Resources Summary Table for the U.S. Economy: CONTROL1085

	1985			1986				Years			
	II	III	IV	I	II	III	IV	1984	1985	1986	1987
Composition of Real GNP - Annual Rates of Change											
Gross National Product	1.9	3.1	2.3	1.5	1.6	2.3	3.1	6.8	2.4	2.1	3.0
Final Sales	4.6	4.6	-0.9	2.5	2.4	2.1	3.0	7.0	3.2	2.2	3.5
Total Consumption	4.8	4.8	-1.3	2.0	2.0	1.7	1.8	5.3	3.9	1.8	2.7
Nonres. Fixed Investment	14.4	2.1	-3.1	-1.8	-2.1	-1.5	2.2	19.8	6.7	-0.4	4.6
Equipment	16.6	3.4	-3.7	-1.1	-0.5	0.2	3.9	21.5	6.1	0.6	6.0
Nonres. Construction	9.2	-1.1	-1.3	-3.6	-4.1	-5.9	-2.4	15.6	8.4	-2.9	0.8
Res. Fixed Investment	6.1	1.7	8.5	9.8	6.5	5.0	4.6	12.2	1.6	6.6	2.6
Exports	-15.2	0.1	10.5	9.2	10.1	10.8	11.2	4.7	-4.0	7.1	9.9
Imports	-0.7	-0.4	9.9	-2.8	-3.9	-2.2	-2.2	27.0	7.3	0.0	1.0
Federal Government	-0.3	0.4	1.1	-0.6	-0.3	-1.0	2.1	5.4	6.8	0.7	2.3
State and Local Governments	0.8	0.5	1.2	0.8	0.4	0.3	0.1	2.2	2.5	1.4	0.6
Real GNP (1972 Dollars)	1671.3	1684.0	1693.5	1699.8	1706.4	1716.1	1729.0	1639.3	1678.1	1712.8	1777.4
Gross National Product	3853.1	3911.5	3969.1	4014.3	4089.5	4113.7	4182.0	3662.8	3866.1	4092.4	4416.6
Prices and Wages - Annual Rates of Change											
Implicit Price Deflator	2.8	3.0	3.7	3.1	3.0	3.1	3.6	3.8	3.7	3.2	4.0
CPI - All Urban Consumers	4.2	2.4	3.0	3.4	3.7	3.2	4.0	4.3	3.4	3.5	4.0
Producer Price Index - Finished Goods	2.3	0.0	1.8	1.2	2.7	2.7	3.0	2.1	0.9	1.8	3.2
Compensation per Hour	3.3	2.2	4.3	5.0	4.4	4.7	4.9	4.2	3.8	4.2	5.4
Output per Hour	1.1	1.2	0.9	0.6	0.8	1.3	1.7	2.7	0.2	1.0	1.9
Production and Other Key Measures											
Industrial Production (1967=1.000)	1.663	1.670	1.674	1.676	1.678	1.691	1.709	1.631	1.666	1.688	1.783
Annual Rate of Change	3.4	1.7	0.8	0.6	0.5	3.2	4.2	10.5	2.2	1.3	5.6
Nonfarm Inventory Accum. (1972 Dollars)	4.9	-0.4	12.9	8.7	5.2	5.9	6.2	20.9	8.3	6.5	11.7
Housing Starts (Mil. Units)	1.772	1.762	1.885	1.819	1.852	1.885	1.909	1.766	1.798	1.866	1.864
Retail Unit Car Sales (Mil. Units)	10.9	12.0	10.5	10.6	10.6	10.6	10.5	10.4	11.1	10.5	10.7
Civilian Unemployment Rate (%)	7.3	7.2	7.3	7.3	7.4	7.5	7.6	7.5	7.2	7.5	7.4
Federal Budget Surplus (NIA)	-214.1	-194.6	-193.2	-189.2	-184.0	-177.6	-171.4	-175.8	-191.7	-180.6	-168.5
Foreign Trade - Billions of Dollars											
Current Account Balance (Deficit='-')	-147.2	-124.5	-135.0	-128.4	-127.1	-123.7	-118.3	-101.5	-127.0	-124.4	-107.0
Merchandise Trade Balance (NIA Basis)	-126.2	-126.7	-138.8	-135.5	-135.2	-133.1	-127.4	-106.2	-125.7	-132.8	-116.2
U.S. Dollar Exchange Rate (%Change)	-10.5	-21.5	-16.9	-15.9	-15.5	-13.5	-7.2	7.2	3.7	-15.7	-4.6
Foreign Industrial Production (%Change)	4.0	2.0	1.8	4.1	3.0	2.2	3.0	5.9	3.1	2.9	1.9
Financial Markets											
Money Supply (M-1)	582.6	606.2	617.7	626.4	635.8	644.0	652.3	553.5	617.7	652.3	686.6
% Chg. vs Year Ago (Annual: Q4/Q4)	7.3	10.2	11.6	10.3	9.1	8.4	5.6	5.2	11.6	5.6	5.3
New AA Corp. Utility Rate (%)	12.00	11.64	11.43	11.11	10.74	10.56	10.50	13.42	11.94	10.73	10.85
30-Year Treasury Bond Rate (%)	10.99	10.56	10.31	9.84	9.35	9.20	9.22	12.39	10.86	9.41	9.60
Treasury Bill Rate (%)	7.46	7.13	7.06	6.88	6.49	6.52	6.62	9.52	7.46	6.62	7.46
Federal Funds Rate (%)	7.92	7.86	7.78	7.40	6.98	6.73	6.94	10.22	8.01	7.01	8.04
Prime Rate (%)	10.20	9.50	9.50	9.38	9.03	8.78	8.72	12.04	9.93	8.97	9.96
Standard & Poors Common Stock Price Index	184.80	191.92	193.72	195.81	198.88	202.91	204.67	160.46	186.94	200.57	212.65
Incomes - Billions of Dollars											
Personal Income	3174.7	3203.8	3247.5	3303.4	3350.9	3399.5	3453.1	3012.2	3194.9	3376.7	3629.1
Real Disposable Income (%Ch)	8.2	-3.4	2.9	2.4	1.8	2.0	2.8	6.7	2.3	1.9	3.2
Saving Rate (%)	5.1	3.1	4.1	4.2	4.2	4.2	4.3	6.1	4.2	4.2	4.8
Profits Before Tax	221.0	213.0	219.5	219.3	221.4	228.4	237.8	235.7	219.0	226.7	271.6
Profits After Tax	137.4	136.0	139.3	138.3	140.2	143.6	147.9	145.9	137.4	142.5	162.7
Post-tax Corp. Cash Flow	476.5	485.5	491.3	491.5	499.6	502.9	508.1	442.1	479.4	499.5	526.7
% Change vs Year Ago	8.5	8.4	7.6	5.8	4.0	3.6	3.4	16.2	8.4	4.2	5.5

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IS FREE TRADE ALWAYS THE RIGHT POLICY?

The large merchandise trade deficit in the United States has caused great worries in our country regarding the loss of jobs implied in this deficit as compared to the employment opportunities that would occur with a more balanced trade position. Accordingly, the principle of "free trade" appears to be threatened by demand for tariff protectionism. Yet, in my view, the problem is typically not being discusssed in the correct analytical framework in many public forums and in the media. Until we get our analysis right it is unlikely that we can get our policy right. I therefore thank the Committee for giving me this opportunity to set the matter straight and to indicate why I believe the Trade Emergency and Export Promotion Act is an important positive step.

Free trade should not be a goal in itself. Even in textbooks which advocate free trade as beneficial under what economists call the "law of comparative advantage", there are assumed underlying conditions which are required to demonstrate the desirability of free trade. These underlying conditions are [1] full employment of all trading partners, and, [2] a balance of trade in goods and services and hence the absence of "cash-flow" or liquidity problems. Free trade, when less than full employment conditions prevail and when one (or more) of the trading partners run up current account surpluses which are used merely to build up huge liquid balances (at the expense of deficit nations), need not be a desirable position. Indeed "free trade" without full employment and with liquidity imbalances can ulitmately result in undesirable economic and politcal consequences for all capitalist nations.

In the absence of full employment conditions, conventional attempts to

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reduce trade deficits (such as those recommended by the IMF) can cause unnecessary deletorious effects for the deficit nation and (often) for surplus economies as well. Under the traditional "rules of the game" of free trade, there is little economic pressure on any surplus nation to alter its trading stance; economic pressures normally force the trade deficit nations to make all the trade adjustments. For most deficit nations, in the absence of international cooperation to resolve a continuing trade inbalance problem, there is not choice of adjustment, according to conventional wisdom, except to lower the living standards of its citizens —even if there already exists large scale unemployment in the deficit nation. Moreover, the reduction of living standards in the deficit nations reduces export orders to the rest of the world with the result that, all other things being equal, global employment, output, and wage and profit income will all be lower than otherwise.

Since belt-tightening adjustment by trade deficit nations have immediate strong deletorious effects on its citizens' living standards as well as depressing employment effects in the rest of the world, then, in a world which already has significant unemployed resources, civilized behavior should require that both the surplus and the deficit nations make adjustments to alleviate the trade imbalance without depressing the world economy further. This is especially true if intelligent cooperative adjustments can reduce the volume of unemployed resources —and hence increase real income —globally. Intelligent adjustments by both the surplus and deficit trading partners can lead to a movement closer to global full employment with the potential of real gains for all via the adjustment process.

History has already provided an example where positive action by a

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surplus nation to unilaterally reduce its surplus led to improved economic well being for all nations. After the World War II, the United States necessarily ran huge trade surpluses with its trading partners around the world. But instead of allowing these surpluses to be converted into a piling up of liquid claims against the deficit nations (which would have lead to long term impoverishment [and possible politcal unrest] in Europe and Asia), the U.S. redristributed much of these huge potential surpluses via the Marshall Plan and other foreign aid programs. (Direct overseas investment by U.S. corporations was, of course, another surplus reducing factor.) The result was not only to improve the economic standard of living of residents of the war-torn deficit nations, but also, to provide foreigners with funds to buy American products, and thus stimulate employment and prosperity in the United States. On the other hand, had the trade deficit nations had to squeeze their economies, after World War II, by tightening their belts to eliminate their trade deficit with the U.S., the result would have been global impoverishment, depression and probably political revolution. Thus the US experience of the immediate post World War II trade imbalance adjustments should suggest that mere reliance on the deficit nations to make all the adjustments under a "free trade" principle, need not provide an optimal solution.

Currently, under the principle of free trade, surplus nations are under no obligation to alter their trade stance or otherwise provide international transfers without strings, to ameliorate the imbalance. Traditional free trade rules create economic pressures only on deficit countries to make the entire adjustment. In most cases, the deficit trading nation has neither the economic clout nor the expert advice necessary to develop policies to

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encourage surplus nations to join in a cooperative attack on the problem—even if cooperation can result in a better resolution of the problem.

The post World War II huge trade surpluses of the United States gave our nation the opportunity to improve global economic well being (and in so doing foster the growth of democratic capitalism in Europe and Japan) by actively reducing our surplus position rather than foisting the whole adjustment burden onto the deficit nations. The huge trade deficit currently being run by the United States can provide us with an opportunity to re-establish, this time from the position of the deficit nation, this principle of fostering adjustments by both the surplus and deficit nations, in conditions of less than global full employment.

If properly developed and understood, such policies can result in cooperative action to improve the economic well being of all nations and to stabilize the political basis for modern capitalistic economic development. I believe that the Trade Emergency and Export Promotion Act provides a pragmatic approach to induce surplus nations to cooperatively take positive actions to improving the current trade imbalance and hence improve real living standards throughout the world.

THE CURRENT U.S. TRADE PROBLEM

A bit of historical perspective on our current international trade situation may be helpful. Since the 1970's, and especially since the first oil price shock, the U.S. has usually experienced merchandise trade deficits, but the net export balance on goods and services tended to be in surplus. Even during the 1979-1982 recession in the United States this net export position was positive. Only following the recovery, in late 1982, did the net exports position of the U.S. turn strongly negative. This export

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deficit has continued ever since as the U.S. has grown faster than any other nation since the world-wide recession which began this decade.

Some have claimed that the (merchandise) trade deficit is solely due to an overvalued Dollar making our industries noncompetitive with the rest of the world (even though we have experienced significant merchandise trade deficits for most years since the breakdown of the Bretton Woods agreement and the resulting large swings (upward and downward) of the U.S. Dollar). The dollar declined by more than 10% of its 1973 value by the end of 1978 as Secretary of the Treasury Blumenthal "talked" down the dollar in the hopes of stimulating employment via exports without exacerbating inflation. By late 1978, the U.S., in cooperation with other major nations, intervened with an historically large package, to steady the dollar. It remained steady at this rather depressed level until 1980. By early 1981, however, the dollar had already surpassed its 1973 value in trade and by mid-1982 it was more than 20 % above its 1973 value, while the U.S. net goods and services export position was still in surplus. This net export surplus declined in late 1982 and then disappeared only after the U.S. economy experienced a recovery from the worst recession since the Great Depression. As growth accelerated in 1983, the U.S. net export position turned negative as the recovery induced Americans to buy more goods, including imports. The resulting huge trade deficit came, therefore, primarily as the result of the recovery and relative prosperity in the last few years while growth in the rest of the world was small or imperceptible. The trade deficit, therefore is not solely, or even primarily, the result of an overvalued dollar.[1]

1. In fact, as Sir Harold Lever noted in the July 1985 issue of the Lloyds Bank Review, the rising exchange rate is not due to any huge increase in foreign funds being invested in the U.S. since 1982, but rather to a drop

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in US bank lending overseas. Lever notes that "between 1982 and 1984 the inflow of foreign money into the dollar increased hardly at all....[but] according to the official figures, which are known to be incomplete and which understate the drop, [U.S.] bank lending fell from over 100 billion dollars in 1982 to virtually nothing in 1984... because of the [international] debt crisis. This contrasts with a deterioration in the U.S. current account of $90 billion.

Despite the recovery the economy has not moved backed towards the full employment rates of the 1960's or even the 1970's as some of the demand stimulating policies of that great Keynesian in the White House, Ronald Reagan, leaked out and created job overseas. Despite the 6.9% unemployment rate reported for August 1985, unemployment remains above the 6.3 % or less rate achieved by the Carter Administration in all but its last few months in office. The current high unemployment rate combined with a high trade deficit rate has lead some to demand "protective" tariffs to restore jobs in specific import competing industries, rather than to use tariff policy to induce surplus nations to spend more on U.S. goods and services.

Free trade advocates, on the other hand, advocate a "soft landing" for the dollar rather than protective tariffs to restore jobs in these specific import competing industries. (A soft landing implies a "slow" reduction of some 20 to 30% in the dollar exchange value in international trade.) In either case, however, the standard of living of the average U.S. citizen is likely to decline significantly as a ceteris paribus result of either of these policies. In the case of industry protective tariffs, aggregate real income may stagnate if all that is to be accomplished is that the domestic import competing industries products replace imports in the consumer's market basket at higher real costs. On the other hand, a soft landing may not create many jobs or much additional income (see below), while it will increase the costs of many imported products (not just those competing with

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domestic industries) for American consumers, thereby drastically reducing our standard of living. Reducing the trade imbalance while simultaneously expanding real aggregate income and consumption requires a more innovative approach — which is possible as long as unemployed resources are readily available.

In the following section I will explain why I believe that the "soft landing" approach is a phantasmal solution to our trade problem. At this point I would merely state, without taking time to discuss the point, that because of our unique position as the de facto international Central Banker, our current trade imbalance has not put as much economic pressure upon us to resolve the export deficit problem as it would put on an ordinary deficit nation. Moreover, as the Central Banker of the free world, there is less need for us to run an exact trade balance. Nevertheless, in the absence of an explicit aggreement for a new international monetary system to replace the Bretton Woods system, the current U.S. trade deficit, while not unsustainable and not without some very desirable effects, does create problems for the existing international payments system.

The desireable effects of our export deficit include the "engine of growth" aspect which has at least prevented Western Europe from falling into an even greater recession than it experienced in the early 1980's. In the absence of these U.S. trade deficits, all other things being equal, unemployment in Europe would now be substantially higher. With approximately a quarter or more of the under 24 year old labor force unemployed in many European nations today, a lower U.S. trade deficit due to our unilaterally reducing imports, might cause the unemployment rate among European youth to soar even higher, thereby inducing the potential for higher crime rates and

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political unrest in the Western Europe.

The problems our trade imbalance cause in the current economic environment include: (1) the need for maintaining higher liquid reserves to preserve orderly, efficient foreign exchange markets (this is particularly true in Japan where the Central Bank has adopted a more interventionist exchange rate policy than most), (2) the longer term problem of maintaining an orderly international monetary system which is essential for the maintenace of efficient trade relations; and (3) the potential for speculative manias between the dollar and other surplus nations's currencies. Ultimately, I believe these liquidity problems will force the major trading nations to develop a cooperative institutional framework for more actively managing the world's monetary relations.

I would hope that Section 103 of the Trade Emergency and Export Promotion Act would be interpreted as supporting such an international institutional arrangement. I believe that the other sections of this Act contain a pragmatic approach to alleviating these export deficit problems -- especially in the absence of other institutional means for coordinating international adjustments.

A POLICY FOR REDUCING OUR EXPORT DEFICIT

Those who recommend a "soft-landing" for the dollar do not realize that any reasonable decline in the value of the dollar can not dramatically alter our merchandise trade imbalance -- which has been in deficit for many years. The soft-landing approach assumes that given the world aggregate demand for goods, a reduction in the value of the dollar will encourage foreigners to buy more U.S. produced goods and U.S. residents to buy less imports so as to eliminate this deficit which is expected to be approximately

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$150 billion in 1985.

Unfortunately reducing the value of the dollar is unlikely to eliminate or even dramatically reduce our merchandise deficit. First, as The Economist (July 19) reported, more than half of the U.S. merchandise trade deficit results from trading with non-oil exporting Latin American and Asian countries whose currency is tied to the U.S. dollar ($22 billion) plus oil imports ($55 billion) whose price is also fixed in terms of dollars. Hence a devaluation of the dollar will not increase competitiveness in these areas; moreover they might hurt the total export earnings of Latin American nations that already have difficulty paying their debts to U.S. banks.

The main competitive gain from devaluation might be by way of an increased agricultural export surplus, but former importers of U.S. grains (India, China, Saudi Arabia) now pay farmers subsidies to prevent using up their dollars on grain imports, and hence it is not clear that these countries would increase the dollar value on grain imports even at a lower dollar cost (although they might increase the physical volume of grain imports). Hence any soft landing can marginally improve, at best, only some portion of the remaining half the trade deficit, while it could threaten the U.S. banking system because of its impact on the ability of debtor nations to service their loans. And even if the soft landing was successful in choking off all imports -- except oil and from those LDC whose currency is tied to the dollar -- the remaining trade deficit would still be in the neighborhood of $77 billion.

Finally, even much of this remaining half of the trade deficit is unlikely to be substantially reduced by a decline in the value of the dollar. Manufacturers in countries such as Japan and West Germany have often

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experienced huge windfall profits while the dollar was high and could afford to reduce their dollar price as the dollar declines in value. Without stiff tariffs and with a lower dollar, U.S. manufacturers would find Japanese and German prices still too competitive to reduce the remaining half of the U.S. deficit significantly.

Some have suggested that a significant reduction in the $200 billion government deficit would in tandem with a soft landing eliminate our trade deficit. Any delibrate reduction in the government deficit, ceteris paribus, will reduce the trade deficit by lowering GNP, employment and income, and therefore imports below current levels, but only by exacerbating weaknesses in the an economy which currently has too many unemployed. A U.S. recession is the last thing the U.S. or the world needs!

Although it is looks as if the U.S. is caught between a rock and a hard place, there are somethings that can be done to improve our trade position and global economic well-being.

First, the oil trade deficit could be attacked directly through a large, say $10-a-barrel, tax on crude oil or products imported from any Organization of Petroleum Exporting Countries source (thereby excluding Canada, Mexico, Britain, and any other oil country which severes its ties with OPEC). I have advocated this discriminatory import levy against OPEC for over a decade in testmony before the Joint Economic Committee and several other Congressional Committees as a way to encourage the collapse of a cartel. (A cartel which has caused enormous harmful economic effects on the rest of the world — and from which we still suffer.) This discriminatory tax levy may now also play some significant part in reducing our current trade deficit.

Secondly, a method of encouraging trade surplus nations to spend more of

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their liquid hoardings on imports from its trading partners should also be an explicit part of our trade policy. Here the Trade Emergency and Promotion Act can play an important role. By threatening stand-by import duties against countries with large trade surplus against the U.S. and/ or the rest of the world, we can encourage these surplus nations to avoid the tariff and the possible loss of their share of the huge American market by spending more of their earnings on U.S. imports. Although one can quibble about the actual magnitudes used to define "excessive trade surpluses" of trading partners, I believe that the intent of this act is an excellent pragmatic approach to a serious problem. Perhaps the only important suggestions for improvements I would make are (and only the first suggestion is really important currently):

[1] To exempt surplus nations who are using a significant portion of their surplus [say 70% or more] to service their foreign debt obligations; and [2] to encourage countries that have huge trade surpluses, even if they can not be found to have imposed "unfair trade barriers", to make some effort towards reducing these surpluses by either buying additional imports, making grants to LDCs, or engaging in more direct foreign investment. Countries that conmtinually run large surpluses and are not providing grants or direct foreign investments are acting as potential drags on the economic growth of the rest of the world as well as constraining the standard of living of their own citizens below what their citizens have earned!

In sum, I strongly urge the Congress to adopt the Trade Emergency and Export Promotion Act as an important stepping stone in improving world trade performance and global economic well being.

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Senator BENTSEN. Mr. Davidson, you have stated some strong views and they are of great interest to us and we will get to some questions in just a moment.

Let me say first, Mr. Thurow, you were making a statement about massive intervention in currencies and you also stated that there's a great deal of debate whether that can be effective today.

What's happened from January until now to the value of the dollar as related to the mark and the yen and other currencies of the world? My understanding is that we have had a very substantial reduction in the imbalance between the dollar and the European currencies, but not so much with the yen.

I understand the Japanese say they have not intervened, but I can't help but wonder. And yet, is information available to make such a determination?

Mr. THUROW. Well, I think two things should be said. First of all, you remember that there was a big runup in the value of the dollar in January and February and most of the decline since February has just offset that increase in January and February. So the value of the dollar is approximately where it was 1 year ago. We had a runup and then a rundown, but we haven't had any real major decline. You're also quite right to point out that most of the decline has been vis-a-vis European currencies.

One of the big problems with our dealings with the Japanese is we take an American lawyer's view of a nonlegal society. So if you ask the question, Has the Japanese Government intervened to stop the yen from rising? The legal answer is no; they haven't done that.

But in a nonlegal society where you can use administrative guidance, you can quietly say to Japanese firms, "Hey, we think you ought to be keeping your American earnings in America and moving some of your capital to America," and it happens. But there's no law saying it has to happen. The Government has never taken any actions itself where you can find in its books that it's bought or sold yen or dollars.

So at one and the same time the answer can be, no, the Japanese Government has not intervened to affect the yen; and yes, it has intervened to affect the yen because it has ways to intervene that you couldn't do in the United States in our kind of legal society.

I think the same thing is true with our trade negotiations with the Japanese. We take an American lawyer's view. We go over to Japan and we say, "Let's find that magic law that stops Americans from selling things in Japan." We look around for 1½ years and we find some rule or regulation and then we yell about it for 3 years and then we negotiate about it for 2 years. Eventually, they change it. And then 1 year later we find it didn't make any difference anyway because it wasn't an important rule or regulation in the first place.

In a nonlegal, administrative guidance, consensus society, laws aren't important. This is one of the reasons you have to do something like your bill. You have to put the tennis ball in their court. Let them decide how to handle the problem. You couldn't rebuild Japan to open up their markets if you wanted to. They've got to do it themselves. Only they know how their society is in fact constructed.

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The trade negotiation strategy that we've been following for the last 10 years is a dismal failure. It's dismal in its results and no matter how long we follow it, it will always be dismal.

Senator BENTSEN. I noticed in your column a couple weeks ago in the New York Times you were talking about the difficulty that American industry would have in recapturing both foreign and domestic markets, even if the dollar continues to decline.

Now the President is about to propose some trade legislation, as I understand it. It will focus on selective items and would amount to perhaps $3 billion. That's comparable to the errors and omissions figure on our $150 billion trade deficit.

How far do you think that kind of action would go in restoring some balance?

Mr. THUROW. I don't think that kind of action would do very much at all. First, as you point out, $300 million is nothing compared to $150 billion.

Second, in many ways, that's more protectionist than a general measure. I am against all of these bills that protect textiles, that protect automobiles, that protect this or that. That's precisely the route we don't want to go.

But we do want to do something to put real pressure on surplus countries to make adjustments and have them rebuild their economy. If you look at history, it's easy to understand why it's hard to export into Japan. They were a very poor country which for a long time had no money to buy imports, but they wanted to grow rapidly. To do that, they had to design an economy that can grow without imports.

Then very suddenly they became a wealthy country with lots of foreign exchange and they had an industrial structure that just didn't match current demands. But they find it as politically hard to change their industrial structure as we would find it in the United States. But that doesn't mean they don't have to change. It means that there has to be some impetus in the system to make those kind of changes.

Senator BENTSEN. Congresswoman Fiedler has another commitment, and I would like to yield to her now to ask such questions as she desires.

Representative FIEDLER. Thank you very much, Senator.

I'm trying to understand what your rationale for this particular approach really is. What you're really saying is that we will impose a 25-percent surtax on various countries with whom we have an imbalance. While I can see that would be a distinct advantage to the U.S. Treasury, I'm not quite certain how that is going to affect our competitive edge in other parts of the world.

Would either or both of you please explain how you expect that change to take place?

Mr. DAVIDSON. Well, first of all, the competitive edge assumes that there's only a given demand for products and if firm A sells its products firm B doesn't. Both of the witnesses, and I think the Senator's bill, prefer, to increase total demand, so if there's a bigger market and everybody kept their same share, there would still be an expansion. The bigger demand is going to come from the surplus countries, I think I would have used a speed limit analogy. You can pay people to do the right thing, or your can fine them to

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do the right thing and this is an attempt to say you don't have to pay a fine if you obey the speed limit. And socially desirable action is keeping a fairly good balance of exports and imports.

Representative FIEDLER. I don't disagree with that at all, and I'm not sure this is the right or wrong approach. What I'm trying to find out is how you expect to go from taxing their imports to greater U.S. exports? What is going to be the shift? How is that, in fact, going to take place?

Mr. THUROW. You've made the wrong assumption. You have already assumed that Korea, Taiwan, and Japan will not respond and that, therefore, the tax will be levied.

What you want is for the Koreas, Taiwans, and Japans to say, "Look, we have to expand our economy so that it absorbs more imports in order not to pay that tax."

Now let's think about the Japanese automobile industry. In one way it's a very strong industry. It makes 11 or 12 million cars. That makes it the world's first or second biggest car industry.

On the other side, it's a very weak industry because they only buy 5 million domestically. That means they make 7 million cars to export to the rest of the world and half of them go to the United States. They cannot afford to simply say, "We're not going to respond to a bill like this, we're not going to raise imports, and we're just going to pay the 25-percent surtax." They can't afford to give up this market.

Therefore, they are going to take actions to open the Japanese, the Korean, the Taiwan market to goods and services from the entire rest of the world, not just the United States.

Senator BENTSEN. Let me interrupt just a moment to say that I've got a critical vote in the Finance Committee. I have to be there and I'm going to ask Congressman Scheuer to handle the hearing. Thank you.

Representative FIEDLER. Thank you very much, Senator.

Representative SCHEUER [presiding]. Please continue.

Representative FIEDLER. Sir, would you conclude your last statement again?

Mr. THUROW. Well, the point is that you don't want to levy this tax. The purpose of this tax is to persuade some foreign countries to change their internal industrial structure and economic policies to buy more imports. The Japanese Government at the moment is running very restrictive monetary and fiscal policies. A bill like this would encourage them to run a faster economy with more rapid income growth absorbing more imports.

Representative FIEDLER. Right. But what is going to prevent them from doing exactly the same thing to us?

Mr. THUROW. Because if they passed the same law in Japan it would have no effect on us at all. We don't run a large surplus in our overall balance of payments or run a surplus with the Japanese.

Representative FIEDLER. But what would happen if they did what the EEC did with the pasta situation? We put a tariff on their goods, which is designed to force them to improve access for certain U.S. goods. But that is not the result we get. The result we get is that they turn around and slap higher tariffs on another category

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of U.S. goods. That seems to me to be the likeliest—and the traditional—response.

Mr. THUROW. First of all, you're talking about a tax on a specific commodity, which is the wrong way to go.

Second, if you really ask——

Representative FIEDLER. What if it's a global tax?

Mr. THUROW. Who loses the most? Suppose American firms lost everything they now sell in Japan and Japanese firms lost everything they sell in the United States. Who loses the most?

Representative FIEDLER. The consumer.

Mr. THUROW. Well, the Japanese lose the most because they would have two-thirds of their automobile workers unemployed tomorrow morning.

Mr. DAVIDSON. You're making the assumption that the Japanese are not as clever as we all seem to think they are. They will understand what the purpose of this thing is. And the only question is to get them—not to go and have a trade representative say, "Come on, buy some more," and the Premier saying, "Let's have a 'Buy American Week'" and then leave it voluntarily, but to have the Japanese Government undertake policies, which they can do, to increase the demand for imports worldwide, not necessarily the United States.

Mr. THUROW. Think about our trading policies. I remember when we had a deficit with the Japanese of $4 billion and we were following the policies we're now following. The deficit then became $8 billion. Then it became $15 billion. Then it became $37 billion. This year it's going to be $50 billion. If you think of that sequence over the last 15 years, don't you think that's a sequence of failure?

Representative FIEDLER. I totally agree that it is a sequence of failure, and I am not talking as an advocate for existing policy. In fact, I was personally directly involved in the talks with the Japanese on citrus and beef, and understand what we are up against. But in that situation we were able to use certain leverage we had.

The question I'm looking at is not whether or not we need to change our policies. Unequivocally, yes, we must change our policies. They are a failure. I don't think there's any question about that.

The question is, how can we go about making those changes in a way which will produce a positive result as opposed to a negative result? And I think that's the challenge we have before us today.

Mr. THUROW. Read an international trade textbook and they will tell you the right way to get the adjustment is to force the surplus country to adjust because that's the way that expands world trade.

The problem is that all economic pressures normally are on the deficit country to adjust. We get to the point where we have a large debt and the people who have lent us the money say, "We won't lend you any more money." Their prescription for us is going to be import less—do exactly what Mexico is now doing. That will require a fall in the American standard of living and will contract world trade, not expand world trade.

What you're trying to do in many ways is get out of the standard IMF remedy to a debtor nation.

Representative FIEDLER. Thank you for your comments.

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Representative SCHEUER. Professor Thurow, throughout your testimony you kept identifying how in several situations the accepted normal classical rules of economic interplay of forces have simply failed to work.

Can you tell us why they failed to work? What is there unique about the situation in the last 5 years, let us say?

Mr. THUROW. One, you have to remember financial and economic history. Repeatedly through financial history, the financial markets have forced prices to levels which historians record as absurd. The first time, of course, was tulip mania in Holland where the financial markets—free financial markets—put a price of thousands of dollars on individual tulip bulbs. We had the South Sea bubble. We had the Florida land boom. We had the stock market crash of 1929 where the stock market had an absurdly, high value. We had the real estate investment trusts. You can think of many things we've had. I think we will look back on the early 1980's as a time when there was a speculative bubble in the value of the dollar. People were buying dollars and raising it to a level which is absurd because if a country runs a $150 billion trade deficit, that is absurd. If you look at these speculative bubbles they have dynamics. I buy tulips not because I think tulips are worth having, but because I think the price of tulips is going to go up. I buy dollars not because I think the dollar is a strong currency in any fundamental sense, but because I think that tomorrow morning it's going to go up.

Those kinds of things don't last for 3 weeks. They last for a substantial period of time. Tulip mania lasted for 4 years. The South Sea bubble lasted for 7 years. The Florida land boom lasted for 4 or 5 years. The stock market boom of the late 1920's was a 5-year phenomenon. Those kind of financial seculations, bubbles, whatever word you like, are repeated in economic history, and I think we've got one of those at the moment on the value of the dollar.

Mr. DAVIDSON. Let me add one thing. I don't want to deny that speculation has played a part, but if you look at the statistics between 1982 and 1984, the inflow of foreign money into the United States hasn't increased at all.

What has happened is that U.S. bank lending abroad has dropped from $100 billion a year to virtually zero. That's because of the international debt crisis in 1982 when the U.S. banks were scared stiff that all of these foreign countries were going to renege on their debt and so the banks that lend internationally, the U.S. banks that lend internationally, have been trying to get their portfolios in order, reduce their exposure to foreign borrowers. So a good portion of this spectacular rise since 1982 is because of the international debt crisis and U.S. banks making all sorts of adjustments in their lending procedures.

So it's not that more dollars are being sucked into the United States as the fact that they're not being offset as they were in the earlier years by lending of U.S. banks abroad.

Representative SCHEUER. Just one last question. We are approaching the end of our hearing. You heard me ask Mr. Petersen what he advised the President on the subject of the trade deficit, in addition to cutting taxes which is easy rhetoric but when you get down to good hard specifics it gets a little tougher, especially when

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you approach the entitlement programs where a good deal of cutting has taken place already.

If we could disguise you as—well, let's say just taking a random—Mr. Milton Friedman and send you into the Oval Office with Mr. Petersen and Mr. Petersen stopped to draw a breath and you had a chance to interject a few words of advice to the President about how to cope with the deficit, what would you tell him?

Mr. THUROW. He doesn't want to face up to the fact that if you are really serious about eliminating the Federal deficit, raising taxes is going to have to play a major role. There isn't any way to get the $200-plus billion out of Federal spending, however you look at it. Therefore, a major tax increase has to be on the table and if I were to say that they would promptly get me thrown out of the White House because he would know I wasn't Milton Friedman. [Laughter.]

Representative SCHEUER. It seems to me that there are certain taxes that would be acceptable to the American people, certain tax increases. For example, a minimum corporate tax in the nature of 25 percent, let us say, on corporations making several hundred million a year theoretical taxable income, and a minimum tax on individuals making over $100,000 a year who are paying virtually no taxes.

The Congress received a report from the Internal Revenue Service saying that many thousands of taxpayers making aggregate incomes of $100,000 a year and more are paying an average of 6 percent of their income for taxes, which is—well it would be comical if it weren't so painful and so transparently unfair and unjust. And it seems to me the American people would not rise up in anger at the idea of raising taxes on these individuals who are avoiding taxes and on corporations that are avoiding taxes with vast megabuck incomes, and I think the American people also feel that another idea whose time has come is getting a handle on the whole defense economy and the whole procurement process. We had Ernie Fitzgerald up here, the greatest of the whistle blowers, who testified before this committee not many months ago that he thought that with proper procurement practices we could save between 25 and 50 percent of our annual $100 billion procurement budget.

So as Senator Dirksen used to say, "A billion dollars here and a billion dollars there, and pretty soon you're talking about real money."

It seems to me that that kind of an approach has enormous possibilities.

Let me tell you, to brighten up your day, that I just left a group of Members of Congress, a caucus of Congressmen interested in reforming the budget, who do not buy the Marquis of Queensbury ground rules the President has laid out, that the tax reform must be revenue neutral. And under Congressman Tony Beilenson's leadership, a number of us, myself included, are going to work for this kind of a tax reform bill that will bring us to a balanced budget in approximately 3 years.

It's largely at your exhortation and your guidance on previous occasions that have brought us to this point and have provided the intellectual underpinnings for this proposal.

Any response?

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Mr. THUROW. No; I don't have objection to an effective minimum tax for corporations and individuals and I think that makes a lot of sense.

The problem, as you know, is that we pass a minimum income tax and then we put a lot of loopholes in it so most people aren't affected by that minimum tax. If you were to do it, I think you would really want to do it so that there weren't any ways to walk around the minimum tax, so that you could really guarantee that every American or every corporation that was making profits or income was paying some minimum tax that made sense.

Representative SCHEUER. Well, I think the principle of our approach would be, no matter what the deductions might be that the individual or the corporation might have, whether they be depreciation or investment tax credits or what, and even assuming that they eliminated any tax obligation, as is the case with hundreds of large corporations and tens of thousands of individuals, nevertheless, there would be a minimum tax willy-nilly.

Mr. THUROW. Well, let me come down on the side of something Professor Davidson recommended. If you're really seriously thinking about taxes, think about a tax on imported oil.

Representative SCHEUER. Yes.

Mr. THUROW. Every other industrial country that imports oil raises some very substantial amount of revenue with it; $50 billion worth of our trade deficit is oil. We can't afford to buy that oil. Limiting the amount of oil that we import by making it more expensive raises some revenue, helps us on the foreign trade, and makes us less dependent on foreigners for oil, which is all to the good.

The problem is how do you persuade the American people that more expensive gasoline is in their own longrun self-interest?

Representative SCHEUER. We can't afford to buy that oil because of our perception that oil is easily available and cheap. Until we change the perception of the American people that oil is a very scarce commodity and a very valuable commodity and a commodity to be husbanded, we're going to be in serious trouble. And I suppose a tax on imported oil would be reflected ultimately at the gas pump which would certainly concentrate a lot of minds.

Well, we have had a most interesting hearing. We thank you both for your patience and for your endurance in staying with us this morning. We declare the meeting adjourned.

[Whereupon, at 11:45 a.m., the subcommittee adjourned, subject to the call of the Chair.]

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APPENDIX

STATEMENT OF SENATOR LLOYD BENTSEN

It was unfortunate that all committee members could not attend and question the expert witnesses assembled to examine the economic impact of my proposed legislation, in particular, S. 1449, "The Trade Emergency and Export Promotion Act." The witnesses provided pointed comments on this bill, rather than providing broad generalizations regarding tariff legislation of the type exemplified by a recent Congressional Budget Office staff working paper entitled "The Effects of Targeted Import Surcharges." This paper did not examine "The Trade Emergency and Export Promotion Act," did not attempt to empirically examine any trade legislation, and gave an inadequate theoretical treatment of an issue badly in need of extensive, sound analysis.

Drawing on much more extensive resources and expertise, this Nation's largest econometric consulting firm, Data Resources of Lexington, MA, examined "The Trade Emergency and Export Promotion Act." That comprehensive and pointed analysis goes considerably further than shallow broad-brushed papers in exploring the empirical impact of my legislation, used extensive computer regressional analyses. To my mind, that is the type of in-depth analysis which serious students of trade legislation and our trade problems must rely on in forming opinions and especially in making judgments of legislative merit. Public policy decisions should be based on hard, rigorous analysis, not theoretical or classroom exercises without an empirical foundation.

The Data Resources analysis concluded that the economic impact would be dramatic if "The Trade Emergency and Export Promotion Act" succeeds in opening markets like those in Japan which prohibit free import of American goods. I have included a summary of these impacts below and the entire analysis is attached. Moreover, I refer committee members and others interested in this topic—and who did not attend the September 18, hearing—to closely examine the testimony presented that day.

SUMMARY OF DATA RESOURCES' ANALYSIS OF THE ECONOMIC IMPACT OF "THE TRADE EMERGENCY AND EXPORT PROMOTION ACT"

AN ECONOMIC SIMULATION OF THE IMPACT OF OPENING JAPANESE MARKETS TO AMERICAN EXPORTS

The Commerce Department and the State Department have found that U.S. exports could be expanded by $14 billion annually if Japan lowered its export barriers. The economic effects of opening that market through use of S. 1449, the Trade Emergency and Export Promotion Act are measurable. If they were opened next year (1986):

Real GNP growth would increase one-half a percentage point or about $20 billion in 1986.

Based on Oken's law, that would boost total U.S. employment by one-quarter of a percent or some 250,000 jobs next year.

Employment in hard-hit manufacturing industries would increase one-half a percent or some 100,000 next year.

The faster pace of growth would reduce the federal budget deficit by $8 billion.

It would have a dramatic impact on industrial production, increasing it by 0.8 percent or nearly one percent in 1987.

It would not increase inflation or boost interest rates.

The impact of this open market is spread among all manufacturing sectors. The sectors which would most benefit from successful Congressional efforts to open the Japanese market include:

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Industry:	Percent [1]
Tobacco	1.7
Textile mill products	1.2
Lumber and wood products	1.6
Paper and paper products	1.5
Chemicals and products	2.8
Including:	
Basic chemicals	4.0
Synthetic materials	3.4
Drugs and medicines	2.0
Agricultural chemicals	1.7
Petroleum products	0.5
Rubber and plastic products	2.7
Including:	
Tires	1.2
Rubber, excluding tires	1.1
Plastic products	3.1
Glass and glass products	1.9
Metal industries	3.0
Including:	
Steel	3.4
Iron and steel foundries	3.3
Nonferrous metals	2.6
Fabricated metal products	1.9
Engines and turbines	3.0
Farm equipment	1.1
Construction equipment	2.9
Metal working machinery	2.3
Office and service equipment	1.4
Telecommunications equipment	0.8
Household appliances	1.1
Electronic components	1.2
Automobiles	2.3
Trucks, buses and trailers	1.9
Aircraft	2.8
Business equipment (all types)	1.7
Railroad equipment	17.2
Total industrial production	1.2

[1] Production increase in 1986 and 1987 (total).

Virtually every American industry will benefit from a reduction in Japanese import barriers. In a few cases, opening those markets will prevent a drop in production in 1986 which is otherwise projected to occur. These turnaround industries include: Tires, steel, major electrical equipment.

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U.S. Forecast Summary

October 1985

EXPAND OR PROTECT

by Roger E. Brinner

The global economy is close to a trade crisis. The strong dollar produced by conflicting international policies, and the belief that the United States offers a more open market than U.S. producers face abroad, have made protectionism a live policy option.

Although it is almost certain that policy adjustments both here and abroad will be made in the next year, these changes could develop into a protectionist fiasco or an expansionist success. The U.S. manufacturing and agriculture sectors appear to have the political clout to obtain Congressional protection through quotas, tariffs, or subsidies. The better multinational choice is an expansion of overseas spending (stimulated by tax cuts), coupled with an expansion of the U.S. share of markets through a weaker dollar and more open Japanese buying practices.

The "Group of Five" finance ministers--representing France, Germany, Japan, the United Kingdom, and the U.S.--have announced an exchange intervention program to reduce the dollar's value. They have also hinted at monetary and fiscal policy changes designed to justify this lower level. Congress will mull over these initiatives as it moves ahead on the hundreds of trade bills currently under consideration.

POLICY OPTIONS

Exchange Intervention: Intervention can change currency values for a limited amount of time, in advance of an adjustment in economic fundamentals. The announced intervention program represents a wager by the Treasuries and central banks that the dollar deserves a lower value. Although traders will be reluctant to bet against the intervention, financial fundamentals will eventually dominate. For example, a 10-year U.S. government bond offers 10.5%, versus 6.5% for a German bond or 6.0% for a Japanese bond; today's bond yields thus roughly cover a 40-45% decline in the dollar against the mark and the yen over the next decade. The market is neither irrational nor is it moved primarily by abstract notions such as "safe havens"; all policy moves will therefore be judged on their ability to narrow these spreads and thus bring the dollar closer to reasonable long-term values.

Fiscal and Monetary Mix: Narrower spreads can be achieved through any, and hopefully all, of the following measures: (1) adherence to the U.S. House-Senate budget resolution, plus further spending cuts and probably some tax increases in 1987; (2) relatively generous monetary targets for the U.S. as long as producer price inflation remains low; (3) expanded overseas investment of Japanese funds, thus raising costs and yields of yen-denominated investments to world levels; (4) personal tax cuts in Europe and Japan, with no reductions in government spending; and (5) continuation of moderately conservative monetary policies in the Common Market, Japan, and Canada.

Unfortunately, news releases concerning proposed Group of Five fiscal policy adjustments are not encouraging. The U.S. representatives had been convinced that France, Germany, Japan, and the U.K. agreed to change their policies while we would remain on the course already set by the budget resolution. In their announcements to their home constituencies, however, none of the finance ministers indicated they planned major

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new initiatives or an acceleration of previously proposed tax cuts:

> Mr. Lawson (U.K.) reaffirmed the Conservative government's plan to cut income taxes, but gave no timetable.... West German Finance Minister Gerhard Stoltenberg also showed no inclination to push forward to 1987 a tax cut planned for 1988.... In Tokyo, officials at the Finance Ministry said Sunday's announcement did not imply any major policy changes for either fiscal or monetary authorities...that might promote domestic economic growth.... Indeed, European officials said that the major policy change is not required on their part, but by the U.S.[1]

Given that the U.S. feels that it has already promised to make its contribution for fiscal 1986 by cutting the deficit, greater collaboration from the other four nations is essential. Indeed, if such cooperation is not forthcoming, the Group of Five conference may well have been counterproductive by breeding cynicism and anger in the United States.

Protection: The greatest opportunities for opening up markets are in Japan. According to a report by the U.S. Departments of Commerce and State, exports to Japan would be $10-15 billion higher if Japanese markets were as open as those of our other industrialized partners. Although these estimates are quite broad and the background trade-share analysis cannot precisely discriminate between a closed market and an exceptionally undervalued yen, related case studies of telecommunications, electronics, tobacco, and consumer products markets bear out the general proposition that Japan enjoys greater access to overseas markets and technologies than it offers to others.

If overseas economies are not bolstered by tax cuts and if the U.S. share here and abroad cannot be expanded by a more competitive dollar, U.S. protectionist meaures will be difficult to resist politically. If all parties agree that current dollar values are unrealistic, it does not make sense to weaken or to shed industries here because of today's uncompetitive stance. Unfortunately, tariffs and quotas will often fail to address these symptoms, much less the causes of the problem.

Consider three alternative types of protection: a tariff on all imported goods, a set of tariffs (or quotas) on a selected category of goods from all countries, and a tariff on all goods from a selected country (or set of countries). The first option, a broad tariff, would tend to strengthen the dollar, raise U.S. interest rates and inflation, and weaken GNP and industrial production growth. Although both the federal budget and foreign trade deficits would be reduced, the economy would be hobbled by higher costs for almost every item consumed by U.S. citizens or produced for sale here and abroad. Only if the Federal Reserve were to ignore this inflation and other nations eschewed retaliation could this strategy provide even a small near-term improvement.

A tariff restricted to a subset of goods would only help to the extent that the goods are not an input to other U.S.-made goods (whose marketability would be hurt by the tariff) or to the extent that new activities cannot be found for the workers and capital associated with the threatened industry. Steel tariffs present a difficulty precisely because domestic steel users will try to evade the tariff by substituting other materials or by buying the steel and fabricating the final products abroad. The steel industry understands this and therefore sought only temporary relief while it reduced costs and supported action on the federal budget to reduce the dollar's value. The textile and footwear industries fit the second category: the dollar's rise has overwhelmed these industries with intolerably large market losses.

The final tariff option, a broad tariff against a small list of countries, makes sense if it can be successfully used as a bargaining device to open unfairly closed markets. As a recent DRI study urged, imposition of a 20% country-specific tariff could provide foreign central governments the national leverage to reverse protectionist pressures in individual industries.[2] To avoid or reduce the tariff, the targeted nation would have to reduce its multilateral trade surpluses according to a negotiated schedule. In the case of a country

[1] Wall Street Journal, September 24, 1985, p. 33.

[2] Christopher Caton, "The Effects of a Temporary Impact Tariff," March 1985 Review, pp. 13-20.

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such as Japan, multilateral surpluses must be the measure of compliance, or our gain could become a Canadian, European, or LDC loss.

IMPACTS OF TRADE-RELATED POLICIES

The DRI Model provides a useful format for quantifying the opportunities and the risks of alternative trade policies. The results of our analysis of a general import tariff of 20% in 1986, 15% in 1987, and 7% in 1988 are summarized in Table 1. Half the burden of the tariff is presumably borne by foreign producers and half by the domestic economy. Nevertheless, the tax would still reduce U.S. manufacturing output and employment through its impacts on the exchange rate, real consumer income, imported intermediate goods prices, and domestic credit costs.

Table 1
Dynamic Effects of the Import Surcharge
(Difference from base case)

	1986	1987	1988	1989	1990
Federal Surplus* (Billions)	-71	-60	-19	14	-5
Current Account* (Billions)	-58	-59	-26	3	-1
Gross National Product (%)	-0.2	-0.8	-1.1	-0.8	-0.1
Consumption (%)	-0.6	-0.8	-0.8	-0.6	-0.4
Business Fixed Investment (%)	-0.1	-0.6	-1.2	-1.7	-1.5
Residential Investment (%)	0.1	-1.2	-2.2	-1.3	1.9
Government Spending (%)	0.0	-0.2	-0.4	-0.4	-0.1
Exports (%)	-0.2	-1.7	-2.6	-1.3	0.8
Imports (%)	-1.3	-1.7	-0.6	-0.8	-1.5
Industrial Production (%)	-0.5	-1.5	-2.2	-1.4	0.6
Consumer Price Index (%)	0.8	0.8	0.4	0.0	-0.2
Exchange Rate (%)	1.6	3.9	2.1	-1.4	-3.4
Money Supply (M1) (%)	0.9	0.5	-0.2	-0.5	-0.1
Unemployment Rate (%)	0.1	0.3	0.4	0.3	0.0
3-Month T-Bill Rate (Basis points)	15	40	35	-15	-85
Housing Starts (Thousands)	-4	-16	-36	-12	55
Car Sales (Thousands)	-390	-300	-300	-200	0

*Negative numbers indicate a smaller deficit.
Source: Christopher Caton, "The Effects of a Temporary Import Tariff," March 1985 Review, pp. 13-20.

The role played by monetary and fiscal policies can best be illustrated by comparing two simulations designated CONFLICT and EXPAND. The first assumes that the U.S. passes no deficit reduction measures and that foreign governments take no action to stimulate their economies—in other words, that the conflicts between U.S. fiscal and monetary policies and between U.S. and foreign fiscal policies continue. Interest rates rise sharply as the federal demand for national savings continues to grow. Although stronger federal spending sustains growth through 1986, the U.S. economy moves into a recession in 1987. The spread between U.S. long-term bonds and foreign bonds once again widens: after averaging 2.4% in 1984 and falling to 1.1% as of the third quarter of 1985, the spread expands to 3.3% by 1987. This holds the dollar firm. The Morgan Guaranty index is projected to be 1.27 in 1985, 1.14 in 1986, and 1.23 in 1987, slightly worse than the value of 1.28 immediately before the the Group of Five conference.

The EXPAND scenario, in contrast, incorporates the Control package of federal spending cutbacks, as well as an additional deficit reduction package for 1987 that includes a 2.5% personal and corporate tax surcharge, a 2.5% reduction in entitlements and military spending (relative to the baseline), and a ceiling of 2.0% on federal civilian and military pay increases. Looser monetary policy offsets this fiscal restraint and supports a multinational currency intervention effort. At the same time, Japan, Canada, and the European nations cut taxes to expand their growth by 1% relative to the Control by late 1986; the fiscal stimulus is assumed to be sufficiently large to overcome the greater competitiveness of U.S. producers.

Chart 1
Real GNP Growth Rates
(Seasonally adjusted, annual rates)

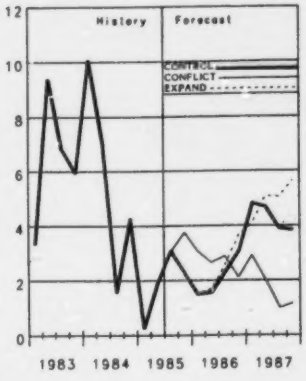

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Chart 2
Consumer Price Inflation
(Seasonally adjusted, annual rates)

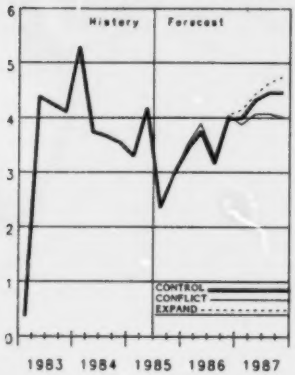

Table 2
Commerce Department Estimates of
Potential Additional U.S. Exports
Assuming An Open Japanese Market
(Data are for 1982 unless otherwise noted)

Sector	Potential Additional U.S Exports (1) (Millions)
Telecommunications (2)	$ 750
Forest Products	2,000
Paper	500
Wood Products	1,500
Electronics	2,150
Components	1,075
Computers	1,075
Medical Equipment and Pharmaceuticals	750
Medical Equipment	400
Pharmaceutical	350
Tobacco Products (Cigarettes)	1,980
Chemicals	1,500
Cosmetics	1,500
Services	
Insurance	200
Brokerage	50
Mutual Funds	50
Processed Foods	NA
Confectionery (mainly chocolate)	50-75 by 1990 (3)
Aluminum	90-100 by 1992-3 (3)
Machine Tools	175
Fish	400 (4)
Beef	280 (4)
Citrus	40 (4)

Note: Differences in industry sector and trade definitions make most of the above data only roughly comparable; in addition, the U.S. share of the world market is the export share only and does not include sales of U.S. affiliates abroad (both exports and "domestic" sales), which are considerable for electronics, tobacco, chemicals, and cosmetics (and probably others). For example, the U.S. share of the world computer market is over 70% if sales of U.S. subsidiaries are included and over 35% of the Japanese market.

(1) Typically derived by making U.S. share of Japanese market equal to U.S. share of world market; in instances where this was not meaningful, simply estimated.
(2) Equipment only; data on telecommunications services not readily available.
(3) Assuming Japanese tariffs are reduced to the level of U.S. tariffs for comparable items.
(4) Assuming that Japanese import quotas are lifted.

This set of policy initiatives induces a major adjustment of relative interest rates, and hence of the dollar's exchange rate. The new economic environment generates substantial growth of U.S. exports, with large feedback effects on domestic income and output. Because U.S. taxes are increased at the same time that federal spending is reduced, the switch to more expansionary monetary policy and a weaker dollar does not produce a problematic increase in inflation. Although the artificially low inflation rates generated by the strong dollar clearly cannot continue, a major wage-price spiral is unlikely.

If Japanese markets could be opened without imposing a tariff, even greater optimism for the U.S. economy would be justified. Table 2 presents the Commerce Department's calculation of the market potential lost due to restrictive Japanese trade practices. In the EXPAND-PLUS simulation, U.S. export demands are raised by these magnitudes over the course of 1986. Obviously, real economic growth would be greater; equally important, the dollar would be strengthened because we could balance our international goods and capital accounts even with stronger prices for our products. These results highlight the fact that restrictive overseas practices reduce U.S. living standards relative to the rest of the world. As a nation, it is desirable to have the dollar as strong as overseas markets will allow.

Tables 3 and 4 summarize the findings of the three special simulations. The Control falls toward the optimistic end of the range by assuming that much of the required adjustment of U.S. fiscal policy will occur and that the Federal Reserve will endeavor to keep interest rates lower than in 1984.

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Forecast Summary

Table 3
Four Economic Futures
(Average growth rates or levels, 1986-87)

	Conflict	Control	Expand	Expand Plus
Policy Assumptions				
U.S. Fiscal 1987 Budget (Billions of dollars)	No Deficit Restraint	Current Budget Resolution	Current Budget Resolution plus Tax and Spending Package	Same as "Expand"
Expenditures	1,109	1,037	1,023	1,022
Interest	169	150	146	147
Taxes	864	866	879	887
Deficit (NIA)	-245	-171	-144	-136
Structural Deficit	-179	-103	-77	-76
U.S. Monetary	Restrictive	Supportive	Expansionary	Same as "Expand"
Reserve Growth	3.8%	5.9%	7.5%	7.5%
10-Year Bond Rate	11.5%	9.5%	8.8%	8.8%
M2 Growth	5.0%	7.2%	7.7%	7.9%
Foreign Fiscal	No New Stimulus	No New Stimulus	Broad Tax Cuts	Same as "Expand"
Foreign Monetary	No Cooperation	Moderate Intervention	Heavier Intervention	Same as "Expand"
10-Year Bond Rate	8.7%	9.3%	9.9%	9.9%
Foreign Buying Practices	Unchanged	Unchanged	Unchanged	Japan Expands Imports from U.S. by $14 Billion in 1987
U.S. Economic Consequences				
Real GNP Growth (%, Q4 to Q4)				
1986	2.7	2.1	2.4	2.9
1987	1.8	4.3	5.0	5.1
Merchandise Trade Balance ($B'l.)				
1986	-137.9	-132.8	-134.1	-128.6
1987	-126.0	-116.2	-112.9	-103.9
Manufacturing Employment (% change)	-0.2	1.3	2.0	2.5
Industrial Production (% change)				
1986	2.7	1.3	1.6	2.4
1987	1.6	5.6	6.7	7.3
Inflation				
Consumer Prices	3.9	3.9	4.1	4.1
Wholesale Prices	1.4	2.7	3.4	3.5
Imported Goods	0.0	7.8	12.7	12.0
Exchange Rate Index (1980-82=1.00)				
Level	1.19	1.05	0.98	0.99
% Change	4.1	-6.3	-12.5	-11.7

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Table 4
Industrial Output Prospects Can be Improved
(Rates of change)

	Conflict		Control			Expand		Expand Plus	
	1986	1987	1984	1985	1986	1987	1986	1987	1986	1987
Total Production	2.7	1.6	10.5	2.2	1.3	5.6	1.6	6.7	2.4	7.3
Products, Total	2.9	1.5	10.6	3.4	1.8	5.2	2.0	6.2	2.7	6.7
Final Products	3.1	2.4	10.6	3.1	1.8	6.0	2.0	6.9	2.7	7.4
Consumer Goods	2.1	0.9	6.5	2.0	1.1	3.0	1.2	3.3	1.7	3.7
Business Equipment	1.8	2.4	17.3	4.3	1.2	9.5	1.6	12.2	2.8	12.7
Defense Equipment	11.0	8.0	13.1	9.4	6.7	10.0	6.9	10.0	7.4	10.5
Intermediate Products	2.0	-1.4	10.7	4.6	1.8	2.5	2.1	3.7	2.7	4.3
Materials	1.8	1.2	10.7	0.1	0.4	7.1	0.7	8.8	2.0	9.8
Manufacturing	2.8	1.6	11.3	2.4	1.3	6.1	1.5	7.2	2.4	8.0
Durables Manufacturing	1.9	0.8	15.2	2.4	0.3	6.8	0.6	8.5	1.6	9.2
Nondurables Manufacturing	3.9	2.6	6.8	2.3	2.6	5.2	2.7	5.7	3.5	6.5
Primary Processing	3.1	0.8	9.3	1.7	1.6	5.2	1.8	6.1	2.9	7.3
Advanced Processing	2.6	2.0	12.6	2.7	1.2	6.5	1.5	7.8	2.2	8.3
Utilities	1.4	2.5	3.6	2.4	0.9	1.9	0.9	1.3	1.0	1.5
Mining	1.6	1.4	7.6	-1.2	1.5	2.2	1.6	2.6	1.9	2.8
Oil and Gas Extraction	1.8	2.1	4.6	-1.7	1.8	2.1	1.8	2.1	1.8	2.1
Other Mining	1.3	0.0	14.3	-0.1	0.9	2.6	1.1	3.5	2.1	4.4
Ordnance	9.0	7.2	8.3	4.8	3.8	6.1	3.9	4.6	3.9	4.6
Food and Products	3.6	2.3	4.6	3.2	2.9	3.5	3.0	3.8	3.3	4.0
Tobacco Products	2.9	0.9	1.8	-2.1	2.3	0.6	2.4	0.6	3.3	1.4
Textile Mill Products	5.5	2.5	-2.0	-1.9	3.4	6.9	3.4	7.1	3.9	7.8
Apparel and Products	0.6	1.6	8.8	-1.7	-0.9	5.4	-0.9	5.6	-0.5	6.1
Lumber and Wood Products	3.5	-6.3	8.2	4.2	4.3	-0.5	4.7	1.5	5.6	2.2
Household Furniture	4.3	1.6	8.1	-1.9	2.8	4.4	3.0	4.6	3.4	5.1
Fixtures and Office Furniture	-1.0	-2.8	19.7	8.8	-2.3	-1.0	-2.2	-0.9	-1.8	-0.3
Paper and Products	2.6	2.5	7.3	-0.1	1.3	4.2	1.5	4.4	2.3	5.1
Printing and Publishing	4.9	3.7	12.7	5.4	3.6	3.5	3.7	3.1	3.9	3.4
Chemicals and Products	4.0	2.3	6.1	4.4	2.5	6.1	2.8	7.2	4.2	8.6
Basic Chemicals	4.2	-1.1	6.1	2.2	3.3	5.2	3.7	7.7	5.8	9.6
Synthetic Materials	5.8	4.1	9.9	5.7	3.2	10.0	3.5	11.1	5.2	12.8
Drugs and Medicines	4.5	3.4	3.8	1.7	3.7	4.5	3.9	5.2	4.9	6.2
Soaps and Toiletries	3.5	4.2	5.3	9.2	2.0	3.2	2.0	2.2	2.1	2.6
Paints	1.4	-0.5	12.3	1.6	0.0	1.5	0.2	1.9	0.5	2.3
Agricultural Chemicals	0.5	-0.4	12.1	-0.6	1.4	3.8	1.9	6.7	3.0	7.3
Petroleum Products	3.5	1.7	1.4	-0.6	2.7	2.5	2.8	2.5	3.1	2.7
Rubber and Plastics Products	5.5	4.7	12.9	1.9	3.5	9.3	3.7	13.1	4.9	11.6
Tires	2.6	3.6	11.2	-5.7	-0.5	6.6	-0.6	4.6	0.1	5.1
Rubber Excluding Tires	-1.0	-5.8	13.7	1.6	0.0	6.4	0.3	9.4	1.4	9.4
Plastics Products, NEC	7.1	6.7	12.4	3.7	4.7	10.3	5.1	11.2	6.4	13.0
Leather and Products	-4.3	-6.3	-3.8	-9.1	-3.4	4.3	-3.3	7.1	-3.0	6.8
Stone, Clay, and Glass	1.6	-1.6	13.4	2.7	1.1	2.1	1.4	3.2	1.8	3.7
Glass and Glass Products	3.5	0.4	8.0	0.4	2.2	6.7	2.5	6.7	3.7	7.4
Cement and Structural Clay Products	-1.4	-2.8	15.0	4.6	-2.0	0.5	-1.8	1.7	-1.5	2.2
Concrete and Misc. Clay Products	1.4	-2.3	16.0	3.3	1.2	0.7	1.5	1.8	1.6	2.2
Primary Metals	2.3	-1.5	10.1	-3.4	0.2	5.5	0.6	7.2	2.2	8.6
Iron and Steel, Subtotal	1.2	-1.4	11.0	-7.4	-2.2	6.7	-1.8	8.4	-0.2	10.3
Basic Steel and Mill Products	2.0	-1.1	12.3	-5.4	-1.4	6.1	-1.0	7.5	0.4	9.4
Iron and Steel Foundries	-2.6	-2.4	18.4	-5.6	-5.3	7.9	-4.7	10.6	-2.8	12.0
Nonferrous Metals, Subtotal	3.5	-1.5	10.8	1.7	2.8	4.2	3.1	5.8	4.7	6.8
Fabricated Metal Products	-0.6	-0.9	14.5	4.7	-2.4	2.2	-2.3	2.4	-1.4	3.4
Metal Cans	2.5	2.8	2.0	-0.4	0.7	4.8	0.9	5.2	1.5	6.0
Hardware, Plumbing, Struct. Mtls.	-0.2	-0.1	15.0	5.6	-0.8	3.3	-0.6	4.0	-0.3	4.5
Other Fabricated Metal Prods.	-1.9	-2.2	16.9	5.6	-4.8	0.8	-4.7	0.4	-3.2	2.0
Nonelectrical Machinery	1.7	2.3	20.3	3.1	1.4	9.7	1.8	12.6	3.1	13.2
Engine and Farm Equipment	-5.6	-0.9	16.4	-6.2	-0.1	11.6	1.0	19.3	3.1	18.6
Engines and Turbines	-0.5	-0.3	25.7	-0.7	2.9	10.3	3.3	15.8	5.9	16.2
Farm Equipment	-18.4	-2.7	2.8	-16.8	-8.0	14.8	-5.3	28.1	-4.4	28.3
Construction and Allied Equipment	0.9	-2.8	28.6	8.5	0.2	5.7	0.6	8.8	2.3	10.0
Metal Working Machinery	5.1	1.7	22.6	3.7	1.6	8.7	1.9	10.2	3.3	11.1
Spec. and Gen. Industrial Machinery	-0.7	-1.6	20.1	0.3	0.6	7.8	1.0	11.7	2.2	11.8
Office, Service and Misc. Equipment	1.7	5.3	21.4	3.4	1.6	11.1	1.3	13.4	2.3	13.8
Electrical Machinery	1.2	3.8	18.4	-2.3	1.0	13.1	1.4	16.8	2.4	16.9
Major Elec. Equipment and Parts	-1.9	-4.0	12.5	-7.5	-0.7	8.8	-0.2	13.9	1.3	14.0
Household Appliances	2.7	-0.1	15.9	1.2	2.5	5.1	2.8	6.7	3.5	7.1
TV and Radio Sets	-5.1	-11.8	18.3	-14.5	0.7	11.4	1.3	20.2	2.2	19.2
Communication Equipment	4.0	4.3	16.3	8.5	1.5	7.5	1.7	8.4	2.3	8.6
Electronic Components	-0.4	8.4	29.1	-9.3	0.4	21.2	0.9	27.0	2.2	26.9
Misc. Electrical Supplies	-0.9	1.4	11.7	-3.9	-0.8	10.4	-0.5	12.3	0.3	11.5
Transportation Equipment	2.1	-2.3	16.1	7.9	-2.6	2.2	-2.3	2.2	-1.3	3.5
Motor Vehicles and Parts	-3.9	-6.4	19.5	8.5	-7.3	-2.1	-7.1	-2.9	-6.2	-2.0
Automobiles	-7.5	-9.8	12.9	11.5	-11.9	-6.1	-11.8	-8.2	-10.7	-7.0
Motor Vehicle Parts	-3.9	-7.9	18.5	2.9	-6.8	-4.1	-6.6	-4.4	-5.8	-3.5
Trucks, Buses, and Trailers	3.3	2.4	37.2	5.7	0.3	9.0	0.6	8.9	1.6	9.8
Aircraft and Parts	13.3	4.4	7.9	9.0	4.0	7.0	4.2	6.2	5.3	7.9
Ships and Boats	-1.8	-9.8	15.4	2.3	1.2	8.3	2.5	17.9	4.9	19.5
Railroad Equipment	13.2	57.6	83.2	-15.7	7.6	70.4	8.5	78.3	12.1	91.9
Mobile Homes	2.4	-2.8	10.3	13.7	3.2	0.7	3.5	2.0	3.7	1.9
Instruments	2.0	0.9	9.6	2.5	1.2	8.1	1.6	10.6	2.7	11.2
Equipment Instruments and Parts	1.0	1.5	11.1	2.3	0.4	9.6	0.8	12.6	2.0	13.1
Consumer Instrument Products	3.5	-0.1	9.0	2.7	2.5	5.9	2.7	7.6	3.7	8.2
Miscellaneous Manufactures	0.8	-1.6	3.6	-0.9	-0.3	4.8	0.0	6.5	1.0	7.4

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U.S. DOMESTIC BASELINE: ANOTHER YEAR OF SLOW GROWTH

The Control anticipates that third-quarter growth may turn out to be higher than initially estimated by the Commerce Department (2.8%), but settle back down to the 2.0-2.5% range in the last quarter of 1985 and most of 1986. While it is entirely possible that swings in inventory accumulation or in the foreign trade position could boost quarterly growth rates up to 4% or down to a small negative rate, neither a conventional recession nor a strong recovery seems likely.

The healthiest sector in the economy is expected to be residential construction. The monthly data have been disappointing in that starts have not increased substantially with the decline in mortgage rates over the first half of this year. Permits, on the other hand, have been stronger than starts for the past four months (Table 5), suggesting that builders are ready to begin construction when they sense that interest rates have reached a trough and the market presents its best opportunity; at that point, housing starts could easily hit a 1.9-2.0 million unit annual rate for a number of months. The credit market uncertainties created by the dollar intervention, however, may postpone this surge until 1986.

Consumers were in a buying mood in July and August. While demand for motor vehicles was exceptionally strong, this did not detract from spending in other sectors. The saving rate dropped below 3% in August, compared with a normal value in the 5-6% range, as households remained confident that this is a good time to buy. While it is unlikely that the saving rate will return to normal levels immediately, even a gradual increase would drain substantial spending energy from the economy during the next year or two. Since year-end national income account data revisions tend to "discover" more household income, however, the Control minimizes this potential loss by projecting an average saving rate of 4.2% in 1986 and 4.8% in 1987.

Capital spending is the least certain element of the forecast. According to surveys by the Department of Commerce and by McGraw-Hill, business spending should flatten or decline

Table 5
Recent Evidence

	% Change vs. Prior Month				% Change
	May	Jun	Jul	Aug	12 Months
Employment and Income					
Payroll Employment	0.3	0.1	0.3	0.3	3.3
Average Weekly Hours	0.3	0.0	-0.3	0.3	-0.3
Nonfarm Income	0.2	0.4	0.5	0.3	5.6
Disposable Income	1.7	-2.5	0.5	0.2	4.2
Initial Unemp. Claims (Thousands)	386.2	394.7	390.4	382.5	366.5
Real Spending					
Nonauto Retail Sales	-0.3	-1.0	0.2	0.5	3.7
Retail Auto Sales	0.1	-1.3	0.5	6.7	22.0
Consumer Spending	0.3	-0.2	0.3	1.2	5.6
Nondef. Cap. Goods Orders	0.5	8.9	-4.6	1.7	-0.4
Housing Starts (Millions)	1.68	1.70	1.65	1.75	1.59
Housing Permits (Millions)	1.78	1.71	1.69	1.75	1.54
Industrial Production					
All Industry	0.0	0.2	0.0	0.3	1.1
Manufacturing	0.0	0.1	0.1	0.6	1.3
Consumer Goods	0.4	0.6	-0.2	0.7	2.4
Business Equipment	-0.1	-0.9	-0.1	0.2	1.2

Table 6
Investment Plans
(Percent change)

	1985 Forecasts			1986
	Spending = Volume + Inflation			Spending (SCh)
Commerce Department Survey (9/85)	8.3	5.8	2.4	na
(6/85)	9.2	6.2	2.9	na
McGraw-Hill Survey (5/85)	9.9	4.6	5.1	-1.9
DRI Control				
Total Nonres. Fixed Invest.	9.5	6.7	2.5	2.5
Producers' Durable Equipment	8.2	6.1	2.0	3.4
Nonres. Structures	11.5	8.4	2.9	1.0
Public Utilities	1.6	-0.7	2.3	8.6
Excl. Public Utilities	14.3	11.1	2.9	1.0

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slightly on a quarter-to-quarter basis over the rest of 1985. With the growth recession now a year old and threatening to last for another year, this is a logical outcome. After-tax profits are expected to fall 5.8% in 1985 and to recover only weakly (5.7%) in 1986. The only force that might temporarily overcome this negative environment is the threat of tax reform: projects could be moved forward from 1987 to 1986 to ensure that they receive investment tax credits and depreciation allowances. It should be noted, however, that the Senate will not pass a reform bill in 1985 and is certainly unlikely to pass an anti-investment bill in 1986 with an implementation date earlier than January 1, 1987; to do so would be to risk a recession as voters head for the polls. DRI stands by its earlier criticism of President Reagan's tax reform plan; indeed, further analysis suggests that even investment in nonresidential construction could be hurt.[3]

Financial Markets: As noted in last month's Forecast Summary, the Federal Reserve must choose between achieving its 1985 monetary targets or sustained growth for the economy. Since the economy is expected to receive much higher priority, interest rates should change little during the fourth quarter, with a decline projected next spring.

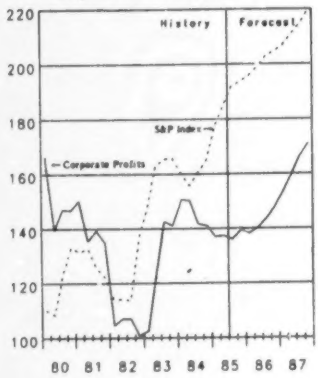
The Federal Reserve has a double incentive to stay on the sidelines. First, real growth in the third quarter was only 3%, in spite of a 5% rise in consumer spending, and inflation has declined rather than risen as the Fed feared. Second, the decision to intervene against the dollar almost certainly means that the bank will have to ignore the overshoots in M1 and M2 targets during the rest of 1985. An attempt to sterilize the intervention would dilute the effort significantly.

At the end of the year, the Fed can set new monetary growth targets for 1986 from a more ample liquidity base. Given the very favorable behavior of all price indexes, the bank's credibility as an opponent of inflation will not have been destroyed by current problems of money growth management. With the economy expected to remain soft in 1986 and inflation projected to remain moderate even as the dollar drops sharply, the Fed should have no trouble keeping M1 growth under 6% next year. As the recession continues, the federal funds rate is projected to average 7% in 1986, 0.75 percentage point below current levels and 1.0 percentage point below the average for 1985; the 30-year Treasury bond yield is projected to average just under 9.5%.

The stock market may perform quite well in such an environment. Because the market tends to look ahead, the prospect of lower interest rates and of an imminent trough in corporate profits is highly favorable. With the dollar turning down, corporations will have a far better opportunity to recover their costs through moderate price increases. On a seasonally-adjusted basis, corporate income may be past its low point in the fourth quarter of 1985. The Control projects a 7.3% rise in the Standard and Poor 500 index in 1986, followed by a 6.0% increase in 1987.

The structure of tax reform is another uncertainty for financial markets. As proposed

Chart 3
Standard and Poor's Composite Stock Price Index (1941-43=10) and After-Tax Corporate Profits ($Billions)



[3]See Roger E. Brinner, "Tax Reform II," U.S. Long-Term Review, Summer 1985, pp. 27-39, for the original study. A follow-up will appear in next month's Short-Term Review.

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by the President, tax reform would mean a substantial reduction in national savings because corporate tax increases would finance large personal tax cuts; this would tend to push interest rates up by at least as much as lower marginal tax rates would depress them. The prospects for the stock market are much less rosy: the heavy increase in corporate taxes would reduce the post-tax return to the shareholder by about 8%.

Given the dominance of the trade issue today, the House Ways and Means Committee may not be able to produce a tax reform bill this year, although they are still promising to try. The Senate is even less likely to produce a tax bill before next year, and even then, it may bear little resemblance to the President's proposals. Because the structure of the package cannot be reliably anticipated, the Control does not incorporate any tax reform measures.

Inflation Outlook: Data Resources remains on the optimistic side of the consensus regarding prices and wages. The most recent consumer price index report bears out this position, rising by only 0.2% for the fourth straight month. The implied annualized rate of 2.5% is not, however, the new norm for the economy because there are too many special factors involved; it is clear, though, that a prognosis of 5% or worse inflation is not justified.

Energy markets are almost certain to remain a counter-inflationary force to the economy. Saudi Arabia has insisted on an increase in its production levels as winter demand builds up. The time of greatest threat to OPEC's prices is not today, with demand firming up, but rather next year when other OPEC members must agree to reduce output. DRI anticipates that non-OPEC oil production will rise 2.3 mmbd between 1985 and 1987 and that, even with falling prices, world consumption will rise by only 1.5 mmbd. The implied squeeze on OPEC motivates a decline in the U.S. refiners' acquisition price of foreign crude oil from $27.31 this year to $23.56 in 1987. A weaker U.S. currency value will eventually stimulate global demand for oil and raise the odds of a rise in its dollar price; DRI's Energy Service, however, does not expect this to occur until very late in the 1980s or the early 1990s.

The 20% decline in the dollar's value predicted to occur over the next two years will add slightly more than 2% to the level of consumer prices and 4-5% to the level of producer prices; this still implies only 4% growth in the GNP deflator and the CPI by 1987, and a 5.4% rise in compensation per hour. With 1987 being a recovery year, productivity growth should return to about 2%, and unit labor cost inflation--compensation minus productivity growth--will rise approximately 4%. A cost-push inflation cycle is therefore unlikely. The slight inflationary surge expected will be limited to the pass-through of higher prices for imported goods. Competition among domestic producers should be sufficient to keep the inflation rate from spiraling upward far past the range indicated for 1987.

Table 7
Inflation Forecast Summary

	85:1	85:2	85:3	85:4	86:1	86:2	86:3	1983	1984	1985	1986	1987
Hourly Labor Costs												
Wages	3.5	3.2	1.4	3.4	3.5	4.0	4.1	4.6	3.4	3.0	3.4	4.0
Total Compensation	5.0	3.3	2.2	4.3	5.0	4.4	4.7	4.8	4.2	3.8	4.2	5.4
Productivity	-3.3	1.1	1.2	0.9	0.6	0.8	1.3	3.4	2.7	0.2	1.0	1.9
Unit Labor Costs	8.5	2.2	0.8	3.4	4.3	3.5	3.3	1.3	1.4	3.5	3.2	3.5
Price Indexes												
CPI	3.3	4.2	2.4	3.0	3.4	3.7	3.2	3.2	4.3	3.4	3.3	4.0
WPI--Farm	-11.3	-10.3	-13.5	7.1	-10.2	5.4	0.7	2.5	3.0	-10.4	-5.3	1.6
--Energy	-4.9	3.4	-10.4	-4.0	2.2	-6.1	-9.8	-4.1	-1.2	-4.0	-3.8	-2.5
--Nonenergy Industrial	0.6	1.2	1.3	2.1	3.1	3.6	4.1	2.3	2.9	1.2	2.8	4.2
GNP Deflator	5.4	2.6	3.0	3.7	3.1	3.9	3.1	3.8	3.8	3.7	3.2	4.0
Non Oil Imports	-9.3	1.4	3.8	10.2	12.0	15.4	15.1	-0.8	-0.5	-2.2	11.1	9.6
Exchange Rate	22.5	-10.5	-21.5	-16.9	-15.9	-15.5	-13.5	4.0	7.2	3.7	-15.7	-4.6

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RISKS TO THE FORECAST

The risks to the forecast are becoming more balanced, but the incoming economic data and economic policy statements remain equivocal. The Control assumes that the economy muddles through in 1986; although growth remains sluggish, a recession is avoided as the weaker dollar and the lower interest rates counteract the cutbacks in federal spending and the need for households to retrench. As Chart 4 indicates, this forecast assumes that monetary policy remains relatively loose and investment continues to show moderate growth. The dollar declines steadily over the forecast period. Any tax bill passed is modified to have a minimal impact on the economy.

The major risk is that the economy will weaken in 1986 as households reduce their spending more rapidly than assumed in the Control. In PESSIM1085 (probability = 0.20), a mild recession begins in the second quarter of 1986 and the Federal Reserve eases monetary policy. The resulting lower interest rates and weakening of the dollar permit a strong recovery in 1987. The risk of a recession in 1986 would increase if the Fed becomes alarmed about the excessive growth of the monetary aggregates and tightens financial conditions.

Chart 4
Context Map of DRI Forecasts

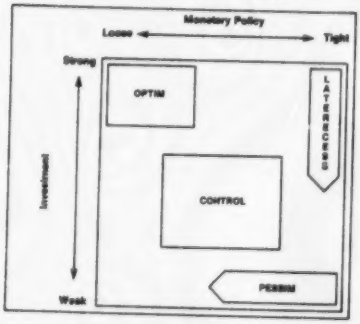
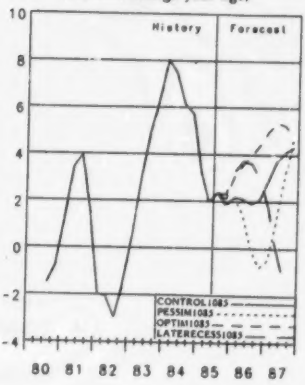


Chart 5
Real GNP Growth
(Percent change year ago)



In the OPTIM1085 scenario (probability = 0.10), consumers continue to borrow heavily in spite of their growing debt burden. The Federal Reserve remains loose in spite of rapid GNP growth as concern about the dollar overcomes the fear of inflation. Investors recover their confidence as interest rates drop and final demands strengthen. The economic expansion resumes, with real GNP rising at a 4% annual rate through 1987.

The LATERECESS1085 alternative (probability = 0.10) assumes that the recent strong economic data are harbingers of an early 1986 boom. The Federal Reserve is unwilling to accommodate this strength, however, and interest rates rise in response. The higher interest rates and the growing debt burden force consumers to retrench in early 1987. Investment rises in 1986 as developers try to finish projects before a change in tax laws, but drops off thereafter. After a strong performance in 1986, the economy moves into recession in 1987.

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Table 8
Data Resources Summary Table for the U.S. Economy: Alternative Scenarios

	1985			1986				Years			
	II	III	IV	I	II	III	IV	1984	1985	1986	1987
PESSIMISTIC											
					SAAR						
Real GNP Growth Rates											
Gross National Product	1.9	3.1	2.0	1.8	-1.1	-2.7	-1.1	6.8	2.3	0.7	2.2
Total Consumption	4.8	4.8	-1.3	2.1	0.5	-0.1	-1.2	5.3	3.9	1.2	1.6
Nonresidential Fixed Investment	14.4	2.1	-7.4	-2.2	-5.1	-10.4	-8.9	19.8	6.4	-3.7	0.4
Residential Fixed Investment	6.1	1.7	7.8	6.8	-5.9	-10.7	-13.8	12.2	1.5	0.2	2.1
Total Government	3.7	4.8	1.2	0.2	0.1	-0.7	0.8	3.5	4.2	1.1	1.2
Civilian Unemployment Rate ($)	7.3	7.2	7.3	7.3	7.5	7.9	8.3	7.5	7.3	7.8	8.5
CPI - All Urban Consumers (*1)	4.2	2.4	3.0	3.4	3.8	1.9	2.8	4.3	3.4	3.1	3.1
Producer Price Index - Finished Goods	2.3	0.0	1.7	1.1	2.2	0.9	0.7	2.1	0.9	1.3	1.4
Compensation per Hour (*1)	3.3	2.2	4.2	5.0	4.1	3.9	3.6	4.2	3.7	4.0	4.5
Federal Funds Rate ($)	7.92	7.86	8.47	9.05	9.02	8.44	7.75	10.22	8.18	8.57	7.60
New High-Grade Bond Yield ($)	10.99	10.79	10.90	11.04	11.06	10.93	10.56	12.38	11.15	10.90	10.30
Inventory Investment ($81.)	17.9	7.5	49.8	40.1	23.7	3.6	1.8	58.2	27.7	17.3	18.7
Net Exports ($81.)	-94.0	-94.0	-104.0	-99.6	-95.9	-86.3	-74.1	-64.2	-91.8	-89.0	-65.9
Federal Budget Surplus (NIA, $81.)	-214.1	-194.6	-194.5	-191.9	-198.2	-211.0	-219.8	-175.8	-192.1	-205.2	-218.2
Profits After Tax (*2)	-8.5	-4.0	-2.4	-1.3	-6.0	-12.2	-13.2	14.5	-6.1	-8.2	11.5
Real Disposable Income (*1)	8.2	-3.4	3.1	0.7	-3.5	-3.0	-3.7	6.7	2.4	1.6	1.9
Industrial Production (*1)	1.4	1.7	-0.1	0.5	10.3	10.1	9.8	10.5	2.1	10.2	10.2
Car Sales (Mil. Units)	10.9	12.0	10.5	10.5	10.3	10.1	9.8	10.4	11.1	10.2	10.2
Housing Starts (Mil. Units)	1.77	1.76	1.86	1.77	1.67	1.56	1.49	1.77	1.80	1.62	1.77
OPTIMISTIC	1985			1986				Years			
	II	III	IV	I	II	III	IV	1984	1985	1986	1987
					SAAR						
Real GNP Growth Rates											
Gross National Product	1.9	3.1	3.3	4.1	7.9	4.7	5.0	6.8	2.4	3.8	5.1
Total Consumption	4.8	4.7	-0.6	3.5	3.3	3.1	3.3	5.3	4.0	2.8	4.0
Nonresidential Fixed Investment	14.4	2.2	-1.0	6.3	4.5	6.1	6.0	19.8	6.8	4.3	6.8
Residential Fixed Investment	6.1	2.2	11.3	15.2	9.9	8.6	7.3	12.2	1.8	9.9	4.2
Total Government	3.7	4.8	1.8	1.0	1.0	0.1	1.7	3.5	4.3	1.7	2.0
Civilian Unemployment Rate ($)	7.3	7.2	7.2	7.2	7.1	7.0	6.9	7.5	7.3	7.0	6.4
CPI - All Urban Consumers (*1)	4.2	2.4	2.9	3.4	3.8	3.2	4.0	4.3	3.4	3.3	4.1
Producer Price Index - Finished Goods	2.3	0.1	1.9	1.5	3.0	3.1	3.4	2.1	0.9	2.0	3.5
Compensation per Hour (*1)	3.3	2.2	4.4	4.9	4.3	4.6	4.8	4.2	3.8	4.2	5.3
Federal Funds Rate ($)	7.92	7.86	7.82	7.57	7.32	7.25	7.44	10.22	8.02	7.45	9.13
New High-Grade Bond Yield ($)	10.99	10.83	10.38	9.99	9.69	9.49	9.35	12.38	10.98	9.83	9.84
Inventory Investment ($81.)	17.9	7.1	36.4	29.4	24.5	28.5	33.9	58.2	25.5	29.0	50.9
Net Exports ($81.)	-94.0	-94.0	-98.2	-100.7	-100.4	-92.3	-88.1	-64.2	-90.4	-95.4	-88.2
Federal Budget Surplus (NIA, $81.)	-214.1	-194.7	-189.2	-177.6	-164.6	-148.5	-136.1	-175.8	-190.8	-158.7	-130.0
Profits After Tax (*2)	-8.5	-3.9	1.0	6.8	10.8	18.1	18.9	14.5	-5.2	13.2	13.6
Real Disposable Income (*1)	8.2	-3.5	3.4	3.4	3.1	3.8	3.6	6.7	2.4	2.8	4.4
Industrial Production (*1)	1.4	1.8	3.1	6.1	4.5	8.0	7.9	10.5	2.3	6.5	7.8
Car Sales (Mil. Units)	10.9	12.0	10.6	10.6	10.8	10.8	10.9	10.4	11.1	10.8	11.2
Housing Starts (Mil. Units)	1.77	1.77	1.92	1.96	2.01	2.05	2.09	1.77	1.81	2.03	2.03
LATEST ASSUMPTIONS	1985			1986				Years			
	II	III	IV	I	II	III	IV	1984	1985	1986	1987
					SAAR						
Real GNP Growth Rates											
Gross National Product	1.9	3.2	4.0	4.0	3.7	2.0	1.4	6.8	2.5	3.4	-0.3
Total Consumption	4.8	4.8	-0.5	3.4	2.9	2.6	1.8	5.3	4.0	2.6	0.8
Nonresidential Fixed Investment	14.4	2.7	3.3	5.1	5.1	-0.2	-3.5	19.8	7.2	5.8	-0.9
Residential Fixed Investment	6.1	1.8	11.5	14.7	8.1	5.1	-1.4	12.2	1.8	8.4	-0.2
Total Government	3.7	4.8	1.4	0.6	0.8	-0.5	0.8	3.5	4.3	1.3	1.2
Civilian Unemployment Rate ($)	7.3	7.2	7.2	7.1	7.0	7.0	7.0	7.5	7.2	7.0	7.9
CPI - All Urban Consumers (*1)	4.2	2.4	3.1	3.9	4.4	3.9	4.8	4.3	3.5	3.7	4.6
Producer Price Index - Finished Goods	2.3	0.0	2.3	2.3	3.8	3.9	4.2	2.1	0.9	2.6	3.8
Compensation per Hour (*1)	3.3	2.2	4.8	5.8	5.3	5.4	5.5	4.2	3.8	4.8	5.5
Federal Funds Rate ($)	7.92	7.86	7.87	7.49	7.83	8.27	8.87	10.22	8.03	8.16	8.99
New High-Grade Bond Yield ($)	10.99	10.80	10.58	10.23	10.06	10.25	10.58	12.38	11.07	10.28	11.29
Inventory Investment ($81.)	17.9	7.4	44.0	43.2	44.3	68.5	44.8	58.2	27.5	45.2	-3.3
Net Exports ($81.)	-94.0	-94.0	-104.5	-104.7	-108.3	-109.7	-109.2	-64.2	-91.9	-107.0	-70.9
Federal Budget Surplus (NIA, $81.)	-214.1	-194.4	-186.4	-173.8	-162.4	-138.2	-140.5	-175.8	-190.0	-153.1	-214.0
Profits After Tax (*2)	-8.5	-3.9	3.3	9.7	12.6	0.7	-9.0	14.5	-4.7	9.2	-22.1
Real Disposable Income (*1)	8.2	-1.4	3.4	3.6	3.3	3.1	2.6	6.7	2.4	2.7	2.0
Industrial Production (*1)	1.4	1.9	4.1	4.5	2.3	2.7	-0.2	10.5	2.4	2.9	-1.5
Car Sales (Mil. Units)	10.9	12.0	10.7	11.0	11.0	10.9	10.8	10.4	11.1	10.9	9.8
Housing Starts (Mil. Units)	1.77	1.76	1.87	1.92	1.96	1.97	1.90	1.77	1.80	1.94	1.56

(*1) Annual Rate of Change
(*2) Four-Quarter Percent Change

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My name is Paul Davidson. I live at 18 Turner Court, Princeton, New Jersey. I received a B.S.Degree from Brooklyn College (1950), a MBA from City College of New York (1955) and a Ph. D. from the University of Pennsylvania (1959). I was a member of the Economics Department of the University of Pennsylvania (1954-8; 1961-5). I was an Assistant Professor of Economics at Rutgers University (1958-60). In 1960-61 I was Assistant Director of the Economics Division of the Continental Oil Company. In 1964-65 I was Fullbright Scholar and Visiting Lecturer at the University of Bristol (England). In 1970-71 I was a Senior Visitor at the University of Cambridge. I was a visiting professor at the Institute for Advanced Studies in Vienna (1980, 1984) and have been a Professor at the International Summer School of the Centro di Studi Economici Avanzati (Italy) since 1980. I have held my current position at Rutgers since 1966.

I am the author of several books including THEORIES OF AGGREGATE INCOME DISTRIBUTION (1960), MONEY AND THE REAL WORLD (1972, 1978), and INTERNATIONAL MONEY AND THE REAL WORLD (1982). I have coauthored books entitled AGGREGATE SUPPLY AND DEMAND ANALYSIS (1964), MILTON FRIEDMAN'S MONETARY FRAMEWORK: A DEBATE WITH HIS CRITICS (1974) and a monograph entitled DEMAND AND SUPPLY OF OUTDOOR RECREATION (1969). I am the author or coauthor of articles that have appreared in various professional journals including THE AMERICAN ECONOMIC REVIEW, THE ECONOMIC JOURNAL, THE JOURNAL OF POLITCAL ECONOMY, OXFORD ECONMIC PAPERS, CANADIAN JOURNAL OF ECONOMICS, ECONOMETRICA, PUBLIC FINANCE, LAND ECONOMICS, THE JOURNAL OF POST KEYNESIAN ECONOMICS, THE SOUTHERN ECONOMIC JOURNAL, REVIEW OF ECONOMICS AND STATISTICS, BROOKINGS PAPERS ON ECONOMIC ACTIVITY, ECONOMIE APPLIQUE, HIGHWAY RESEARCH RECORD, ECONOMIC INQUIRY, CHEMICAL ENGINEERING PROCESSES, PUBLIC INTEREST, KREDIT UND KAPITAL, JOURNAL OF ECONOMIC LITERATURE, and QUARTERLY REVIEW OF ECONOMICS AND BUSINESS.

STATEMENT OF REPRESENTATIVE DANIEL E. LUNGREN

Mr. Chairman, I commend you for holding this timely hearing on "The Economic Effects of Trade Legislation." The United States is, indeed, confronted with formidable trade challenges—not the least of which are the domestic implications of America's large trade deficit. The question before the Congress, then, is not whether we should be concerned about the economic effects of trade. We are deeply concerned. The question for me, however, is whether our national interests are best served through adoption of policies which call for the imposition of import surcharges against countries with whom this Nation is presently running large deficits. In this spirit, Mr. Chairman, I submit, for the record, a recent Congressional Budget Office Staff Working Paper that was requested by Senator John C. Danforth (R-Missouri), titled, "The Effects of Targeted Import Surcharges." This paper provides sober and expert testimony documenting my concerns.

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THE EFFECTS OF TARGETED IMPORT SURCHARGES

Staff Working Paper
August 1985

The Congress of the United States
Congressional Budget Office

A variety of proposals have recently been made to impose surcharges on imports from selected U.S. trading partners. This report concerns the economic effects of such targeted surcharges. It was requested by Senator John C. Danforth, Chairman of the Subcommittee on International Trade of the Senate Committee on Finance.

The report was written by Everett M. Ehrlich and Elliot Schwartz of CBO's Natural Resources and Commerce Division. Valuable comments were made by Victoria Farrell, Robert Hartman, Steven Parker, and Eric Toder. The report was prepared for publication by Kathryn Quattrone. Inquiries should be directed to the authors at 226-2940.

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THE EFFECTS OF TARGETED IMPORT SURCHARGES

INTRODUCTION AND SUMMARY

The Congress is currently considering a variety of proposals that would impose surcharges on the imports of selected U.S. trading partners. This study discusses the economic implications of such targeted surcharges.

Surcharges, in general, tend to redistribute economic activity and, by doing so, lead the U.S. economy to divert its resources away from the production of those goods that it produces most efficiently. They encourage the production of domestic substitutes for imports and, therefore, increase output and employment in those industries. But these benefits may be offset by losses elsewhere in the U.S. economy by:

- Raising the U.S. price level and, therefore, reducing the real purchasing power of U.S. consumers;
- Raising the prices of imported components or inputs that are used in the production of U.S. goods (such as integrated circuits used in computers or specialized metals used in aircraft engines), thus reducing their competitiveness in world trade;
- Reducing the incomes of those nations that export to the United States and, as a consequence, their ability to buy U.S. exports;
- Forcing a further appreciation of the dollar, thus handicapping U.S. exports; and
- Inviting retaliation by other nations.

Targeted surcharges, in contrast to general ones, raise a variety of other issues. First, what criteria should be used to determine which nations will be targeted? Virtually any criterion contains some element of arbitrariness or unintended effects. Criteria based on merchandise trade, for example, aimed at such nations as South Korea or Taiwan, could also target such nations as Italy or West Germany. A second issue concerns the poten-

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tial for "origin swapping"; that is, substituting imports from untargeted nations for those from targeted ones--such as untargeted Mexican steel for targeted Japanese steel. This possibility makes the effects of targeted surcharges more difficult to predict than those of general ones, since a targeted surcharge could change the composition of U.S. imports without any real effect on their overall level. Such a circumstance would reduce both the negative effects of the surcharge and the benefits it creates for industries that compete with imports. 1/

The effects of surcharges on the targeted nations must also be considered, particularly in the cases of nations that need to run trade surpluses to finance large debt burdens. Brazil, for example, has a $6 billion merchandise trade surplus with the United States, but will need approximately $45 billion in 1985 to pay principal and interest on its outstanding debt to foreign lenders. Finally, the decision to target surcharges implicitly regards balanced bilateral trade as a policy goal. Bilateral trade imbalances, however, may be the norm in a world of nations with diverse resources, abilities, and economic situations. The United States itself, for example, exported 50 percent more than it imported from the European Community in 1980.

Targeted surcharges also raise the issue of the United States' commitment to the procedures set forth in the General Agreement on Tariffs and Trade (GATT), the international covenant that has promoted free trade throughout the post-war period. While the GATT sanctions a variety of protectionist practices for nations that are injured by imports of specific goods or by balance of payments difficulties, surcharges aimed at selected nations are not permissible under GATT rules. A unilateral abridgement of GATT procedures of the magnitude of a targeted surcharge may not only invite further action that weakens the GATT, but would call into question the U.S. credibility in other international economic agreements.

GENERAL EFFECTS OF IMPORT SURCHARGES

The economic losses associated with either general or targeted import surcharges can be understood best by comparing a world of free international trade with a world characterized by national economic self-sufficiency. By

1. In fact, considerable administrative effort would be needed to prevent fraudulent circumvention of a targeted surcharge, either by shipping finished goods to untargeted countries for reshipping to the United States, or by misrepresenting the origins of goods in shipping invoices.

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producing and exporting goods that they can make cheaply, relative to other countries, and importing other goods from nations with different relative production costs, all nations can lower the cost of securing the goods they seek to consume. 2/ In contrast, any nation that attempts to be economically self-sufficient endures unnecessary costs, since there are always some goods that a nation wants that are relatively expensive for it to produce because of the specific physical, natural, or human resources required. Nations with limited agricultural capabilities, for example, could find the costs of feeding their populations staggering if left to rely on their own resources. Thus, international trade can facilitate the efficient use of resources by allowing a nation to specialize in forms of production that it does best because of the nature of its productive capabilities and resource endowments, while still securing all of the goods and services it seeks to consume. 3/

Import surcharges--either general or targeted--unravel this fabric of international exchange. To the extent that they are effective, by raising prices for imported goods, they encourage the production of domestic substitutes for those goods and thereby create new output and employment in those industries. But at the same time they lead the U.S. economy to divert resources from its most efficient forms of production toward production of those goods that could more efficiently be purchased from abroad. The redistributive effects of surcharges may favor some individual industries over others, but a loss of economic efficiency for the economy as a whole is almost inevitable. This loss, in turn, lowers long-term economic growth and standards of living.

The negative effects of an import surcharge are more widely dispersed than their positive effects, which are concentrated on import-competing industries. But these negative effects are nonetheless tangible, and materialize in a number of ways. First, by restricting foreign competition, surcharges lead to higher prices for domestic goods, thus lowering the purchas-

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2. In the language of economics, this capability is called "comparative advantage." A nation has comparative advantage in the production of a good when it can produce that good at the greatest cost advantage (or least cost disadvantage) relative to other goods, when compared with the parallel cost advantages of its trading partners. Even a nation without an *absolute* cost advantage in the production of any good can identify one good i. which its costs, relative to its trading partners, are the least disadvantaged. It is this *comparative* advantage that brings about specialization in international trade.

3. For further detail, see Congressional Budget Office, *The Effects of an Import Surcharge on National Welfare: A Qualitative Analysis*," Staff Working Paper (March 1985).

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ing power of U.S. consumers. Moreover, since surcharges lead to a higher price level, they make any given monetary policy appear more restrictive, and could, therefore, lead to higher interest rates and further reductions in output. In addition, many U.S. industries produce exportable finished goods using foreign components (for example, U.S. computers often include foreign semiconductors); the competitiveness of these exports would be hurt by the higher prices surcharges would create for their component parts. A surcharge that reduces imports also reduces the volume of U.S. dollars exchanged for foreign currencies with which to buy foreign goods, and is therefore likely to appreciate the dollar relative to other currencies, which would penalize U.S. exports. Internationally, restricting other nations' exports to the United States may lower their societal incomes and, therefore, reduce their ability to purchase U.S. exports. Finally, trade restraints such as import surcharges invite retaliation by nations that are injured by them--in fact, under the General Agreement of Tariffs and Trade (GATT), it is their right. This raises the prospect of a "trade war" that damages all those concerned. 4/

Beyond these effects, surcharges do not address the primary source of the U.S. trade deficit--the high value of the dollar in international exchange markets, which is caused, in large part, by large U.S. budget deficits. 5/ Budget deficits are linked to trade deficits through international capital flows. Federal deficit spending must be accommodated by private sector saving, but given competing private sector demands for funds (such as for investment or consumer credit), the existing level of private saving falls short of satisfying all of these demands. For the major trading partners of the United States (as a group), however, the opposite situation prevails: saving is a higher proportion of national income, and the demands for saving (both public sector deficits and private sector borrowing) are relatively low. Thus, the United States has been able to borrow extensively from abroad to finance its budget deficits.

But this extensive borrowing from abroad (as much as $100 billion in 1984) also increases the demand for dollars, since foreigners who seek to lend funds to the United States must buy dollars in order to do so. This demand bids up the price of dollars--the exchange rate--on international

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4. In fact, the trade wars precipitated by the Smoot-Hawley tariffs of the 1930s led to a collapse of the international trading system, contributing to the length and depth of the Depression.

5. For more on this relationship, see Statement of Dr. Rudolph G. Penner, Director, Congressional Budget Office, before the Subcommittee on Economic Stabilization, House Committee on Banking, Finance, and Urban Affairs (July 18, 1985).

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markets. In fact, between January 1980 and March 1985, the dollar rose by 60 percent (corrected for inflation) against other major currencies. The dollar's high value makes U.S. exports more expensive abroad and makes foreign goods less expensive in the United States. In fact, one recent analysis estimated that dollar appreciation explained 87 percent of the total deterioration in the nominal trade deficit between the fourth quarter of 1980 and the fourth quarter of 1984.[6] As a result, the United States incurred a current account deficit of $101.5 billion in 1984.[7] As long as U.S. fiscal deficits necessitate extensive foreign borrowing, this pattern of a sharply appreciated dollar and significant trade deficits could persist.

Bilateral trade deficits also reflect the economic policy considerations just discussed. The United States' largest bilateral merchandise trade deficit--$37.2 billion in 1984--was with Japan. Trade restraints exist, both in the United States and Japan, and those in the latter have contributed to the large Japanese merchandise trade surplus with the United States, while, on balance, our trade restraints may have curbed it somewhat. The Japanese trade surplus, however, has grown dramatically in the recent past, while no evidence suggests that the level of protection in either market has grown at a comparable rate. The growing Japanese trade surplus may be more readily explained by a U.S. budget deficit and a U.S. saving rate that are, respectively, far greater and smaller than their counterparts for our trading partners, including Japan. As a result, Japan has become a substantial net contributor to the global capital pool, while the United States has been a substantial net consumer of global saving. These capital flows have helped bid up the price of dollars relative to the yen, leading to a dramatic deterioration in the U.S. trade balance with Japan.[8]

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6. See Congressional Budget Office, *The Economic Budget Outlook: An Update* (August 1985), p. 50.

7. The current account deficit is the sum of the merchandise and services trade deficits, including financial transfers. In 1984, the U.S. merchandise trade deficit of $123.3 billion was offset by a $21.8 billion surplus of services trade and other earnings. The terms "trade deficit" and "trade balance" used in this report refer to the merchandise balance, unless otherwise stated.

8. This process has been augmented by the recent deregulation of Japanese capital markets, allowing larger capital outflows from Japan. Thus, to some extent, capital outflows from Japan and their effect on the dollar-yen relationship could represent a correction of the currency pattern that existed when Japanese capital markets were regulated. That is, the yen may have been relatively overvalued in the past as a result of restrictions on capital outflows from Japan.

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SPECIFIC EFFECTS OF A BILATERAL SURCHARGE

Beyond the general effects of import surcharges, surcharges targeted at individual nations or groups of nations have other implications. These issues include how nations targeted for surcharges would be chosen, the prospects for widespread "origin swapping" (in which imports from untargeted nations are substituted for imports from targeted ones), the effects of a surcharge on the targeted nations, and the desirability of balanced bilateral trade as a policy goal.

Criteria for Targeting

Implementing unilateral restrictions on the exports of specific countries presents several problems. First and foremost is the choice of criteria for choosing targeted nations.

Market Access. One frequently cited criterion is market access, often termed "fair trade" or "reciprocal trade," in which markets abroad are sought to be as open to imports as are corresponding markets in the United States. While it may be that U.S. markets are generally more open than their foreign counterparts, it is extremely difficult to measure "openness." Studies of Japan, for instance, find that its trade surplus with the United States is not primarily the result of trade barriers but rather of basic economic factors, such as the dollar's value and Japan's relative cost advantages in many manufactured products.[9] Average tariff levels in both nations are at approximately the same low levels; in fact, average Japanese tariffs are somewhat lower than those of the United States. Non-tariff barriers (NTBs)--that is, actions or policies that keep out foreign goods--are often more difficult to measure. Every country maintains some NTBs (for example, the United States restricts imports of textiles and steel, just as France impedes imports of some electronic equipment). In other cases, NTBs are difficult to identify. For example, are domestic health and safety standards or specifications for product reliability a barrier to imports specifically, or are they an exercise of national sovereignty designed to promote social welfare? Most analysts believe that NTBs probably account for a small percentage of the overall U.S. trade imbalance with Japan and other countries, even though they may be extremely important in the trade of specific goods.

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9. See, for example, Gary Saxonhouse, "The Micro-and Macroeconomics of Foreign Sales to Japan," in *Trade Policy in the 1980s*, William R. Cline, ed. (1983) Institute for International Economics, Washington, D.C.

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Trade restrictions are usually applied to individual commodities. A criterion of "fair" or "reciprocal" trade in all markets is somewhat arbitrary. On average, current international trade practice aims at a broader standard of equivalence of protection--that is, it allows a nation to balance its trading partners' restrictive practices with comparable protection in different markets. Thus, surcharges targeted at individual nations will penalize imports of all goods from those nations, whether they are fairly or unfairly traded. The effect of such action is unclear: would it encourage greater openness in markets that are now closed, or hinder the application of current trade rules and encourage further market restrictions?

Bilateral Trade Deficits. The bilateral merchandise balance has also been suggested as a basis for targeting. One proposed criterion is the ratio of exports to imports, with surcharges aimed at nations with ratios above some trigger level. 10/ It should be noted, however, that such a criterion might have condemned large U.S. trade surpluses in the past. In 1980, for example, the U.S. exported nearly 50 percent more merchandise than it imported from the European Community. Table 1 shows 1984 bilateral and multilateral trade data for the countries with which the United States had the greatest bilateral trade imbalances. Included on the list are Japan, Taiwan, West Germany, Hong Kong, Brazil, Italy, and South Korea, in descending order of their merchandise trade balances with the United States. 11/ Combined, these countries accounted for over 60 percent of the total U.S. trade deficit in 1984.

The merchandise trade deficit, however, is only one component of a nation's trade with the rest of the world. An alternative measure of trade might be current account surpluses (the current account includes services and financial transfers, making it a better indicator of a country's total external balance) or current account surplus as a percentage of GNP. On a current account basis, U.S. performance does not appear to be as bad as it does when one views merchandise trade alone. On a worldwide basis, the United States imported nearly 60 percent more merchandise than it exported in 1984, but this figure drops to 28 percent on a current account

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10. H.R. 3035, for example, would impose surcharges on all nations with nonoil merchandise export to import ratios above 1.65 in their bilateral trade with the United States, or 1.50 on a global basis.

11. Bilateral balances are those reported by the United States. In some cases, multilateral trade data are either unavailable or available only for early years, raising questions about the appropriate data base for calculating trade deficits.

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basis. Using the current account as a criterion for bilateral targeting would have produced a very different list of countries than the one presented in Table 1. Its use as a trigger, however, could lead to an overly retaliatory policy in the near future when capital income flows to the United States, which have been in surplus, turn to a deficit, as the United States becomes a net debtor nation.

Similarly, the merchandise trade surpluses of other nations look less imposing when viewed from a current account perspective. Japan's global current account surplus is still relatively high, at $35 billion, but substantially less than its global merchandise trade surplus of $44 billion. Moreover, because of current account deficits other countries that might be targeted on the basis of large bilateral merchandise trade deficits with the United States have much smaller, or negative, current account to GNP ratios. Brazil had a bilateral merchandise trade surplus of $5.6 billion with the United States in 1984, but, as a result of payments on its large foreign debt, had a current account to GNP ratio of negative (-) 3.2 percent in 1983 (the last year for which these data are available). West Germany, which ran a bilateral merchandise trade surplus against the United States in 1984 of 1.5 percent of its GNP, and a bilateral merchandise export/import ratio of 2.0, had an overall 1.0 percent current account to GNP ratio and a global current account export/import ratio of 1.1 in that year. Moreover, singling out the merchandise trade account as a criterion for targeting surcharges, as opposed to the broader current account, makes the implicit judgment that trade in merchandise is more valuable or important than comparable trade in services.

Origin Swapping

Targeted surcharges are prohibitions on nations, not goods. Restrictions on imports from targeted nations could be overcome in the aggregate by shifting the origins of imports. To the extent that these shifts lead newer, higher cost exporters to enter markets, economic efficiency and U.S. real incomes would be reduced. At one extreme, targeted surcharges could lead to a round of counterproductive "origin swapping," in which targeted nations send their exported goods to non-U.S. markets, while the existing exporters to non-U.S. markets divert their merchandise toward the United States. For example, Japanese steel might be diverted from the United States to the European market, while French steel would be substituted for absent Japanese exports in the United States market. To the extent that such origin swapping occurs, losses in efficiency in the United States would be less than if there were not the possibility of shifting suppliers. But even in

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the extreme case where existing suppliers were only rearranged, these imports would be redirected to destinations with higher transportation costs and, therefore, global economic efficiency would still be reduced.

In the long run, if foreigners did not expect the surcharge to be removed, new sources of imports could emerge. Table 2 lists the leading suppliers of some major U.S. imports from possible target countries (see Appendix I for a more detailed listing). As the table shows, significant alternative sources already exist for many products. For example, in the short run, a surcharge on steel and semiconductors from Japan could, to some extent, be made up from imports from Canada, South Asia, and elsewhere. If these nations provide alternative exports, the overall U.S. trade position would not change, although higher production and transportation costs from alternative suppliers would be incurred. Moreover, to the extent that imports from targeted nations are not replaced by alternative imports, they would be replaced by domestic substitutes at the cost of the losses in economic efficiency referred to above.

Effects on Targeted Nations

Restrictive trade action can have serious effects on the domestic economies of targeted countries. If the targeted country cannot find alternative markets for its products, its national income will be lowered. This can have two important negative consequences for the United States. First, lower income in the targeted country will translate into fewer purchases of imports from the United States. In the case of some small countries, this may be of negligible importance to the United States. But even Japan, with which the U.S. runs a large trade deficit, consumed U.S. merchandise exports valued at $23.2 billion last year. Lower income in Japan would tend to reduce that figure, and would have a contractionary effect on the U.S. economy. Second, and perhaps more significant, to the extent that the target country is hurt, it will have strong incentive to retaliate by restricting exports from the United States. Retaliation would certainly have a negative effect on the U.S. economy and could lead to further retaliation.

Targeting on the basis of bilateral surpluses can penalize a country whose overall trade is in deficit, but happens to have a trade surplus with the United States. Italy and South Korea, for example, had overall merchandise trade deficits in 1983, while running trade surpluses with the United States. Moreover, some countries need to have trade surpluses, at least temporarily, to compensate for previous large trade deficits and to repay their debt to foreigners. For example, Brazil had large merchandise trade deficits until 1981 (in fact, its current account remains in deficit), and

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TABLE 2. LEADING SUPPLIERS OF MAJOR U.S. IMPORTS FROM POTENTIAL TARGET COUNTRIES, 1984 (In millions of dollars)

Product (Standard Industrial Code)	Leading Suppliers	U.S. Imports (In millions of dollars)	Percent of Total U.S. Imports of Product	Percent of Total Imports From Country
Motor Vehicles and Car Bodies (3711)	Japan	15,187	41.07	25.16
	Canada	14,585	39.44	21.80
	West Germany	4,582	12.39	25.73
	Sweden	1,236	3.34	36.08
	United Kingdom	504	1.36	3.35
Total		36,094	97.60	
Steel Products (3312)	Japan	3,100	30.61	5.13
	Canada	1,300	12.84	1.94
	West Germany	997	9.84	5.60
	South Korea	722	7.13	7.20
	France	508	5.02	5.97
Total		6,627	65.44	
Radio and TV (3651)	Japan	5,759	61.51	9.54
	Taiwan	1,001	10.69	6.22
	South Korea	845	9.03	8.43
	Hong Kong	418	4.46	4.70
	Mexico	374	4.45	2.05
Total		8,397	89.69	
Semiconductors (3674)	Japan	1,988	24.38	3.29
	Malaysia	1,454	17.83	51.47
	Philippines	857	10.51	32.68
	South Korea	825	10.12	8.23
	Singapore	673	8.25	16.33
Total		5,797	71.10	
Women's Footwear (3144)	Brazil	728	36.68	8.80
	Italy	526	26.50	6.19
	Spain	247	12.44	9.40
	Taiwan	198	9.97	1.23
	South Korea	104	5.24	1.04
Total		1,803	90.83	

SOURCE: U.S. Department of Commerce.

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has only recently begun to run trade surpluses. These surpluses are necessary for Brazil to repay its external debt, which has been estimated at approximately $100 billion. In fact, to a great extent, Brazil's trade surplus was achieved through restrictions on imports imposed in part by a debt restructuring plan agreed to by Brazil and the International Monetary Fund, in which the United States was a major actor. Brazil's principal and interest payments in 1985 alone might total $45 billion. If Brazil is restricted from earning dollars through trade, it will not have the funds to pay off debts to foreign and U.S. banks. This could have important repercussions on the U.S. banking system, and consequently, on interest rates and overall economic activity.

Should Bilateral Trade Be Balanced?

A final question concerns the desirability of balanced bilateral trade as a policy goal. International trade benefits all nations insofar as it allows each nation the opportunity to specialize in the goods suggested by its resources and its economic conditions. But the process of international trade implies equality of opportunity, not necessarily equality of result. To be sure, each nation's account with the rest of the world must balance: its imports ultimately must be balanced by its exports and its capital inflows (that is, borrowing from abroad). This does not imply, however, that its accounts with each individual trading partner must balance as well. In fact, there is no reason to believe that nations will or should have balanced bilateral trade with each of their major trading partners. All nations have different productive capabilities and different compositions of demand (related to culture or to standards-of-living), all of which change over time. Consequently, the goods and services produced in one country will be more readily accepted in some countries than in others. Bilateral imbalances, therefore, will exist, and can be seen as part of the process by which trade conveys benefits.

Consider the following example. Suppose that the United States were to allow exports of Alaskan crude oil to Japan. These exports are now prohibited by law, but would be economically advantageous given Japan's proximity to Alaska. 12/ Such sales would result in exports to Japan of about $8 billion. Since these sales would displace other oil imports in Japan, it would run a smaller trade deficit with the oil-exporting nations and a smaller trade surplus with the United States. Similarly, U.S. crude oil im-

12. Alaskan oil imports to Japan have been restricted for noneconomic reasons, including national defense and energy security considerations.

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ports would have to replace the oil sold to Japan with oil purchased from other oil-exporting nations. Although such a pattern would change the bilateral balance between Japan and the United States, Japan and the oil-exporters, and the United States and the oil-exporters, it would leave their total trade balances unchanged. Yet, the economic welfare of each nation would be enhanced because oil exports would be redirected to destinations with lower transportation costs.

RELATIONSHIP TO GATT

The rules of international trade are defined by the General Agreement on Tariffs and Trade (GATT), which is incorporated in U.S. law through the Trade Act of 1974, as amended. Since its inception, the GATT has facilitated a tremendous expansion of world trade. The volume of global manufacturing trade has risen at an average annual rate of 7.75 from 1963-1983, while world manufacturing production rose by 4.75 percent a year over the same period. But recognizing that increased trade could create domestic problems for countries receiving large and unprecedented quantitites of imports, the GATT provides a number of specific remedies that countries may invoke to overcome these difficulties. Three of these provisions deserve mention:

- Article XII allows restrictions to safeguard the balance of payments;
- Article XIX allows emergency action to protect domestic producers against injury; and,
- Article XXIII provides for dispute settlement where one party perceives that its benefits under GATT have been nullified or impaired by another.

Balance of Payments Safeguards. Under Article XII of the GATT, to safeguard its balance of payments, a country may restrict the quantity or value of merchandise imports, subject to a number of provisions. With the limited exception of conditions agreed to under International Monetary Fund stabilization programs as part of debt restructuring agreements, countries applying Article XII may not discriminate among supplier countries when imposing import restrictions. But Article XII was written under a fixed exchange-rate system and concerned itself with attempts to defend administered exchange-rates that were no longer justified by economic conditions. It may no longer be applicable under a system of floating rates, where exchange

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rate values, determined by the market, inevitably will lead foreign transactions to balance.

The "Escape Clause". Article XIX, the so-called escape clause, allows countries to use emergency actions to stem imports when they threaten domestic industry. This provision, however, is product-, not country-specific. Except for retaliatory actions taken in response to another country's escape clause action, Article XIX does not allow for targeted action. The issue of "selectivity" (that is, whether restrictions can be targeted against specific countries) is a current topic of international debate and may be subject to change in a new round of GATT negotiations. A surcharge targeted at individual nations, however, does not appear to be permissable under the GATT escape clause.

Dispute Settlement Procedures. Article XXIII establishes procedures for settling disputes whereby a country may seek retaliation if, in its opinion, the benefits that it expects under GATT have been "nullified or impaired" by the actions of another party, such as the breach of a GATT obligation. Such nullification or impairment is implied by most of the Congressional bills and resolutions now pending that urge the President to retaliate against Japan because of its alleged unfair trade practices. This provision does allow for selectivity in singling out transgressors. It is a cumbersome procedure, however, that involves the approval of other GATT signatories and may nevertheless end in failure. 13/

The Most-Favored-Nation Principle and the Issue of Selectivity

Because the most-favored-nation (MFN) clause is viewed as the cornerstone of the GATT system, targeted actions that discriminate among supplying nations are not legal under GATT. They are simply incompatible with the most-favored-nation commitment embodied in Article I, Section I of the general agreement. The most-favored-nation clause requires each contracting party to the GATT to give equal treatment in applying its tariffs and trade laws to all other GATT nations; that is, a country must extend to all other GATT nations the treatment it provides to its "most favored" trade partner. Nevertheless, the perceived need for direct retaliation against specific countries has led to a number of impromptu actions outside of the GATT system, such as orderly marketing agreements and so-

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13 The European Community brought a complaint against Japan's industrial practices that failed in part because of the the ambiguous nature of the trade practices Japan was accused of using.

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called "voluntary restraint" agreements that are in fact country-specific. Frustration over trade imbalances has led some countries, particularly in the European Community, to urge changes in interpretation of the GATT escape clause (Article XIX) to allow for selective and specific actions aimed at particular suppliers. Until now, the United States has offically taken the position that selectivity would be incompatible with the MFN principle and would lead to the demise of the free international trading sytem.

Would selective discrimination destroy the international trading system, or merely recognize a fact of life? Many observers argue that MFN has been compromised already as a result of the proliferation of sanctioned and unsanctioned exceptions that have been instituted in recent years. These exceptions include allowed exemptions to MFN through preferences to developing nations, customs union and free trade areas, and other extra-legal actions such as bilateral restraint agreements. Little doubt exists, however, that if it is recognized as legitimate, discrimination would tend to raise the overall level of protection and reduce the scope and volume of international trade, thereby reducing global economic efficiency. Some observers maintain that there is no way of sustaining an international system without most-favored-nation treatment. From an economic standpoint, MFN assures that imports will come from the most efficient sources and, at the same time, that all markets will be open to a nations' exports. In other words, it gives full play to comparative advantage.

Even if the MFN principle were to be replaced with selectivity or reciprocity, it could be undesirable to abridge the MFN principle outside of GATT negotiations. Even if successful, it would imply the unilateral abrogation of international trade commitments, thus perhaps seriously damaging the international trading system and casting doubt on the willingness of the United States to maintain its commitments to other negotiated international agreements. Moreover, it could force targeted nations to break their commitments to the MFN principle by either retaliating or offering specific trade concessions to the United States.

Unilateral abrogation of the most-favored nation commitment could have serious repercussions. Most-favored-nation treatment has been a powerful force in opening up the world trading system. Under the MFN principle, an explosion in world trade has provided fuel for the post-war expansions in U.S. and world GNP. Movement away from unconditional MFN will inevitably damage the world trading system and lead to distortions in trading patterns that would reduce the efficiency of the global economy and future world standards of living in the future.

The United States has a key role to play in defining the rules of international trade. The challenge is how to recognize and combat the tensions that arise from unbalanced bilateral trade without undoing the history of post-war progress toward a global free trading system.

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APPENDIX I. LEADING SUPPLIERS OF U.S. IMPORTS FROM POTENTIAL TARGET COUNTRIES, 1984 (In millions of dollars and percents)

Product (Standard Industrial Code)	Leading Suppliers	U.S. Imports (In millions of dollars)	Percent of Total U.S. Imports of Product	Percent of Total Imports From Country
Canned Fruits and Vegetables (2033)	Brazil	774	44.64	9.36
	Spain	159	9.17	6.05
	Taiwan	116	6.69	0.72
	Mexico	97	5.59	0.53
	Philippines	81	4.67	3.09
Total		1,227	70.76	
Wine, Brandy, and Brandy Spirit (2084)	France	576	49.53	6.76
	Italy	330	28.37	3.88
	West Germany	106	9.11	0.60
	Spain	75	6.45	2.85
	Portugal	30	2.58	5.79
Total		1,117	96.04	
Weaving Mills, Manmade Fibers (2221)	Japan	286	31.22	0.47
	Italy	229	25.00	2.69
	South Korea	149	16.27	1.49
	China	31	3.38	0.92
	France	30	3.28	0.35
Total		725	79.15	
Men's Shirts and Nightwear (2321)	South Korea	513	20.80	5.12
	Taiwan	497	20.15	3.09
	Hong Kong	457	18.53	5.14
	China	150	6.08	4.44
	Singapore	135	5.47	3.28
Total		1,752	71.05	
Children's Outerwear NEC (2369)	Hong Kong	1,259	30.18	14.15
	Taiwan	767	18.38	4.77
	South Korea	502	12.03	5.01
	China	258	6.18	7.63
	Italy	213	5.11	2.50
Total		2,999	71.88	

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APPENDIX I. Continued

Product (Standard Industrial Code)	Leading Suppliers	U.S. Imports (In millions of dollars)	Percent of Total U.S. Imports of Product	Percent of Total Imports From Country
Leather Apparel (2599)	South Korea	253	66.23	2.52
	Taiwan	26	6.81	0.16
	Italy	16	4.19	0.19
	Argentina	14	3.66	1.34
	Hong Kong	14	3.66	0.16
Total		323	84.55	
Furniture, Fixtures NEC (2599)	Canada	721	28.89	1.08
	Taiwan	528	21.15	3.28
	Italy	178	7.13	2.09
	Denmark	170	6.81	11.20
	Mexico	139	5.57	0.76
Total		1,736	69.55	
Cyclic Crudes and Intermediates (2865)	West Germany	343	22.67	1.93
	Japan	296	19.56	0.49
	United Kingdom	152	10.05	1.01
	Mexico	123	8.13	0.67
	Netherlands	108	7.14	2.49
Total		1,022	67.55	
Industrial Organic Chemicals NEC (2869)	West Germany	338	15.93	1.90
	United Kingdom	315	14.84	2.09
	Canada	233	10.98	0.35
	Brazil	205	9.66	2.48
	Japan	198	9.33	0.33
Total		1,289	60.74	
Miscellaneous Plastic Products (3079)	Taiwan	436	21.03	2.71
	Canada	363	17.51	0.54
	Japan	302	14.57	0.50
	West Germany	183	8.83	1.03
	Hong Kong	142	6.85	1.60
Total		1,426	68.79	

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APPENDIX I. Continued

Product (Standard Industrial Code)	Leading Suppliers	U.S. Imports (In millions of dollars)	Percent of Total U.S. Imports of Product	Percent of Total Imports From Country
Men's Footwear	South Korea	227	25.19	2.26
Except Athletic	Taiwan	157	17.43	0.98
(3143)	Italy	145	16.09	1.71
	Brazil	111	12.32	1.34
	Spain	97	10.77	3.69
Total		737	81.80	
Women's Footwear	Brazil	728	36.68	8.80
Except Athletic	Italy	526	26.50	6.19
(3144)	Spain	247	12.44	9.40
	Taiwan	198	9.97	1.23
	South Korea	104	5.24	1.04
Total		1,803	90.83	
Footware,	Taiwan	1,004	56.95	6.24
Except Rubber NEC	South Korea	444	25.18	4.43
(3149)	Italy	104	5.90	1.22
	France	72	4.08	0.85
	Hong Kong	25	1.42	0.28
Total		1,649	93.53	
Blast Furnaces	Japan	3,100	30.61	5.13
and Steel Mills	Canada	1,300	12.84	1.94
(3312)	West Germany	997	9.84	5.60
	South Korea	722	7.13	7.20
	France	508	5.02	5.97
Total		6,627	65.44	
Printing Trades	West Germany	275	41.86	1.54
Machinery	Japan	147	22.37	0.24
(3555)	United Kingdom	83	12.63	0.55
	Switzerland	51	7.76	1.59
	Italy	34	5.18	0.40
Total		590	89.80	

(Continued)

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APPENDIX I Continued

Product (Standard Industrial Code)	Leading Suppliers	U.S. Imports (In millions of dollars)	Percent of Total U.S. Imports of Product	Percent of Total Imports From Country
General Industrial Machinery NEC (3569)	Canada	519	20.57	0.78
	West Germany	483	19.14	2.71
	Japan	415	16.45	0.69
	United Kingdom	252	9.99	1.68
	Italy	186	7.37	2.19
Total		1,855	73.52	
Office Machines and Typewriters (3579)	Japan	4,135	43.74	6.85
	Singapore	1,006	10.64	24.41
	Canada	870	9.20	1.30
	Hong Kong	696	7.36	7.82
	Taiwan	677	7.16	4.21
Total		7,384	78.11	
Radio and TV Receiving Sets (3651)	Japan	5,759	61.51	9.54
	Taiwan	1,001	10.69	6.22
	South Korea	845	9.03	8.43
	Hong Kong	418	4.46	4.70
	Mexico	374	4.45	2.05
Total		8,397	89.69	
Telephone and Telegraph Apparatus (3661)	Japan	959	51.92	1.59
	Canada	290	15.70	0.43
	Taiwan	206	11.15	1.28
	Hong Kong	133	7.20	1.49
	South Korea	63	3.41	0.63
Total		1,651	89.39	
Radio and TV Communication Equipment (3662)	Japan	1,882	43.81	3.12
	Mexico	773	17.99	4.23
	Taiwan	439	10.22	2.73
	Canada	281	6.54	0.42
	Singapore	217	5.05	5.27
Total		3,592	83.61	

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APPENDIX I. Continued

Product (Standard Industrial Code)	Leading Suppliers	U.S. Imports (In millions of dollars)	Percent of Total U.S. Imports of Product	Percent of Total Imports From Country
Semiconductors and Related Devices (3674)	Japan	1,988	24.38	3.29
	Malaysia	1,454	17.83	51.47
	Philippines	857	10.51	32.68
	South Korea	825	10.12	8.23
	Singapore	673	8.25	16.33
Total		5,797	71.10	
Electronic Components NEC (3679)	Japan	1,259	50.64	2.09
	Mexico	220	8.85	1.20
	Taiwan	147	5.91	0.91
	Hong Kong	133	5.35	1.49
	West Germany	125	5.03	0.70
Total		1,884	75.78	
Motor Vehicles and Car Bodies (3711)	Japan	15,187	41.07	25.16
	Canada	14,585	39.44	21.80
	West Germany	4,582	12.39	25.73
	Sweden	1,236	3.34	36.08
	United Kingdom	504	1.36	3.35
Total		36,094	97.60	
Motor Vehicles Parts and Accessories (3714)	Canada	6,095	55.41	9.11
	Japan	1,853	16.85	3.07
	Mexico	906	8.24	4.96
	West Germany	600	5.46	3.37
	France	453	4.12	5.32
Total		9,907	90.07	
Photographic Equipment and Supplies (3861)	Japan	2,016	67.76	3.34
	Benelux	160	5.38	4.87
	West Germany	118	3.97	0.66
	France	112	3.76	1.32
	Canada	110	3.70	0.16
Total		2,516	84.57	

(Continued)

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APPENDIX I. Continued

Product (Standard Industrial Code)	Leading Suppliers	U.S. Imports (In millions of dollars)	Percent of Total U.S. Imports of Product	Percent of Total Imports From Country
Jewelry and	Italy	646	53.88	7.60
Precious Metal	Hong Kong	127	10.59	1.43
(3911)	Israel	112	9.34	6.19
	Switzerland	72	6.01	2.25
	Peru	34	2.84	2.43
Total		991	82.65	
Sporting and	Taiwan	384	35.13	2.39
Athletic Goods	South Korea	206	18.85	2.05
NEC	Japan	125	11.44	0.21
(3949)	Canada	48	4.39	0.07
	France	40	3.66	0.47
Total		803	73.47	

SOURCE: U.S. Department of Commerce.

NOTE: NEC = Not Elsewhere Classified.

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